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35 ELR 10308 5-2005

ELR
NEWS & ANALYSIS

Corporate Environmental Disclosure Requirements

by Caroline B.C. Hermann

Publicly listed companies have been required to disclose "material" environmental information to investors for over 30 years. Environmental costs can be material when associated with air, groundwater, and waste site remediation, regulatory fines, and litigation that result in losses of millions of dollars, decreased shareholder value, and diminished corporate reputation. Such factors must be disclosed in a company's annual and quarterly reports that are filed with the U.S. Securities and Exchange Commission (SEC). More recently, however, myriad corporate accounting scandals, which have shaken financial markets and caused a decline in investor confidence, have prompted more focus on reporting requirements geared toward establishing increased transparency and accountability. While the new regulations clearly state stiff penalties for failure to disclose, they also create uncertainty as to what, and how, management must now report. Moreover, companies engaging in multinational business must interpret an unfamiliar set of international disclosure regulations.

This Article discusses the new light shed on current environmental disclosure requirements by the passage of the U.S. Sarbanes-Oxley Act of 2002,[1] the European Union (EU) Accounts Modernisation Directive (EU Directive),[2] effective January 1, 2005, and the United Kingdom (U.K.) Companies Act and its accompanying Operating and Financial Review (OFR) requirement,[3] effective April 1, 2005. These regulations expand the role of auditors, and require executive certification of internal controls for timely and accurate reporting of all information, including known environmental liabilities, risks, trends, and uncertainties. The aim is to reinstate investor confidence, and strengthen shareholder rights and third-party protection in public companies.

I. The Need for Accurate Disclosure

Under the Securities Exchange Act of 1933 and the Securities Exchange Act of 1934,[4] the SEC requires issuers of publicly traded securities to disclose material information. In general, information is material if there is a substantial likelihood that a reasonable investor would find the information important to make a well-informed business investment decision.[5] Determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him."[6] Materiality, as defined, is murky at best. Attempts to quantify materiality have used a rule of thumb, for example, to disclose claims equaling $100,000 or more, or 10%, of a company's assets in a current or pending legal proceeding.[7] However, the SEC cautions against relying solely on such benchmarks because they have no basis in law or in accounting standards.[8] Instead, "evaluation of materiality requires a registrant and its auditor to consider *all* the relevant circumstances, and that there are numerous circumstances in which misstatements below 5% could well be material."[9] Failure to disclose material information or making false statements may subject companies to penalties and private law suites.

Corporate financial disclosures present a picture of a company's current financial performance and future projections. Stakeholders, including company management, shareholders, potential investors, analysts, and regulators rely on this public information to make sound business and investment decisions. Within a company, managers and senior executives use financial information to address contingencies, track performance of its subsidiaries and the competition, manage risk, and make strategic decisions such as merging with or acquiring other companies, entering into

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1. Pub. L. No. 107-204, 116 Stat. 745 (2002).
2. Directive 2003/51/EC of the European Parliament and Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC, and 91/647/EEC on the annual and consolidated accounts of certain types of companies, banks, and other financial institutions and insurance undertakings, 2003 O.J. (L 178) 17.7, *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_178/l_17820030717en00160022.pdf (last visited Mar. 8, 2005) [hereinafter EU Directive].
3. Draft of the Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 (2005), *available at* http://www.legislation.hmso.gov.uk/si/si2005/draft/20051592.htm (last visited Mar. 8, 2005) [hereinafter Draft U.K. Companies Act].
4. 48 Stat. 74, 15 U.S.C. §§77a-77mm (requiring issuers to disclose registration and sales of securities); 48 Stat. 881, 15 U.S.C. §§78a-78kk (requiring issuers to file periodic reports).
5. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). *See also* Basic, Inc. v. Levinson, 485 U.S. 224 (1988).
6. *TSC Indus*., 426 U.S. at 450.
7. 17 C.F.R. §229.103.
8. SEC, Staff Accounting Bulletin (SAB): No. 99—Materiality, SAB Release No. 99, 17 C.F.R. pt. 211 (1999), *available at* http://www.sec.gov/interps/account/sab99.htm (last visited Mar. 8, 2005).
9. *Id.* (emphasis in original).

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lease agreements, or conducting property due diligence. Timely disclosure can reveal conflicts of interest, fiduciary breaches, or misfeasance, enabling the company to remedy these issues quickly. Externally, investors use the information to form a clear and comprehensive picture of a company's financials, allowing them to make better-informed investment decisions.

Some companies actively report environmental matters, believing that well-managed financials as well as intangible drivers lead to a sustainable and competitive company. The expectation is that they will be rewarded with enhanced market and shareholder value, less stock volatility, a strong reputation, timely and effective management of risk and opportunity associated with environmental issues, and favorable response from public stakeholders seeking more corporate accountability. Many have yet to correlate reporting extra-financial drivers with an increased bottom line. All too often, environmental disclosure falls under the rubric of corporate social responsibility and is simply not viewed as an important driver for a company's financial success.

In light of these new regulations, however, companies must now view their environmental policies as an integral part of their core business management. Once environmental costs and risks are disclosed, stakeholders will be armed with sound, comprehensive company information to make wise business and investment decisions, thereby contributing to strong shareholder value and markets based on financial integrity. It is in the interest of global markets to have better corporate transparency of information necessary for sound stakeholder decisionmaking.

II. U.S. Financial Reporting Requirements of Environmental Matters

With regard to disclosing material environmental matters, the SEC adopted Regulation S-K, which provides specific narrative disclosure requirements, including environmental disclosure of capital expenditures,[10] legal proceedings,[11] and management discussion and analysis (MD&A).[12] Passage of the Sarbanes-Oxley Act of 2002 did not change the SEC's requirements of environmental disclosure under Regulation S-K. It did, however, emphasize the importance of disclosing environmental liabilities as they pertain to a company's financial condition. No longer can companies subjectively determine whether an environmental matter materially affects earnings. Now, under the Sarbanes-Oxley Act, companies must go beyond a mere baseline requirement, and consider material known trends as well as uncertainties for inclusion in annual and quarterly reports.

A. SEC Regulation S-K, Item 101

Item 101 requires disclosure of the material effects of complying with environmental regulations upon capital expenditures and earnings of its registrant and subsidiaries, as well as material estimated capital expenditures for environmental control facilities.[13] Management should determine both quantitative and qualitative factors, whether a relatively minor impact on the business is important to future profitability, the pervasiveness of the matter, and the impact of the matter.[14] Unknown costs are difficult to estimate when they include, for example, costs from ongoing settlement negotiations or penalties stemming from a newly enacted or adopted regulation. However, to the extent a company has quantifiable environmental exposures, such as being named a potentially responsible party or is on notice for generating hazardous waste, it must report early and give a reasonable estimate of the loss.[15] Moreover, if a company can estimate future material costs "for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material,"[16] those costs must be disclosed since reasonable investors would deem it important to evaluate the future performance of the company.

B. SEC Regulation S-K, Item 103

Item 103 requires material disclosure of current or pending legal proceedings to which the company or its subsidiary is a party.[17] Once a claim is regarded as material, it must be determined whether it is a claim for damages or sanctions that "exceed[s] 10% of the current assets of the registrant and its subsidiaries on a consolidated basis."[18] Or, if it is a government claim involving potential monetary sanctions, it must be reported unless the registrant reasonably believes the sanctions will be less than $100,000.[19] Given the U.S. Environmental Protection Agency's (EPA's) recent increase of maximum penalties for daily civil violations of environmental laws to $32,000, one may need to report a "reasonable belief" that a claim will exceed the $100,000 threshold.[20] Many companies may perceive environmental proceedings as "incidental to the business" and fail to disclose them. Instruction 5 of Item 103 does not exempt ordinary routine litigation if it arises under laws "enacted or adopted regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment."[21] This ensures that environmental proceedings will be disclosed and not inadvertently omitted from the annual or periodic reports.

C. SEC Regulation S-K, Item 303

Item 303 requires senior management to provide a narrative description of its discussion and analysis of a company's fi-

10. 17 C.F.R. §229.101 (Item 101).
11. *Id.* §229.103 (Item 103).
12. *Id.* §229.303 (Item 303).
13. *Id.* §229.101(c)(1)(xii).
14. *Id.* §229.101, Instructions to Item 101, 1.
15. *See* In re Lee Pharmaceuticals, Securities Exchange Act of 1934, Release No. 39843 & Accounting and Auditing Enforcement Release No. 1023, SEC File No. 3-9573 (Apr. 9, 1998) (whereby a company was sanctioned for misstating and omitting the fact that it was named a potentially responsible party for soil and groundwater contamination, had Superfund cleanup costs and liability estimates from its consultants, and that the U.S. Environmental Protection Agency required a site cleanup which it had yet to complete), *available at* http://www.sec.gov/litigation/admin/3439843.txt (last visited Mar. 8, 2005).
16. 17 C.F.R. §229.101(c)(1)(xii).
17. *Id.* §229.103.
18. *Id.* Instruction (B).
19. *Id.* Instruction (C).
20. Civil Monetary Penalty Inflation Adjustment Rule, 69 Fed. Reg. 7121 (Feb. 13, 2004).
21. 17 C.F.R. §229.103, Instructions to Item 103, 5.

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nancial conditions, any changes, and results of operations in its annual and periodic reports, otherwise known as MD&A.[22] This "enables investors to see the company through the eyes of management."[23] The discussion should cover liquidity, capital resources, results of operations, off-balance sheet arrangements, contract obligations, and any other information "necessary to an understanding of its financial condition."[24] This includes known trends or uncertainties that management reasonably expects to have a material impact on its finances,[25] as well as any forward-looking information.[26]

The MD&A is especially affected by the Sarbanes-Oxley Act, which emphasizes greater corporate executive oversight, and certification of accurate financials. Misstatements or omissions of material information in annual or quarterly reports lead to harsh penalties. Since the Act was passed in 2002, the SEC has issued guidance on how to address material trends and uncertainties, i.e., those events or uncertainties for which disclosure is required.[27] The SEC states:

> [C]ompanies should consider the substantial amount of financial and non-financial information available to them, and whether or not the available information itself is required to be disclosed. This information, over time, may reveal a trend or general pattern in activity, a departure or isolated variance from an established trend, an uncertainty, or a reasonable likelihood of the occurrence of such an event that should be disclosed.[28]

This affords potential investors the opportunity to determine "the likelihood that past performance is indicative of future performance."[29] In considering the non-financial information publicly available, such as scientific reports or policy studies, a company may need to report on future trends anticipated to affect a company's financial condition, such as climate change, a new water or air quality regulatory program, unidentified contaminated sites, or as-yet-unknown environmental issues with a newly acquired property. The SEC encourages forward-looking disclosure by providing a safe-harbor rule to protect reporting companies from being penalized under applicable federal securities laws for stating a trend that could prove to be false.[30] To foreclose liability for making forward-looking statements, they must be "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[31] The SEC has also suggested that since quantifying significant effects of known material trends and uncertainties can promote understanding, they should be considered and may, in fact, be required if relevant and the information is reasonably available.[32]

While companies are attempting to quantify impacts that have yet to occur, courts are delineating what constitutes a forward-looking statement. A recent decision from the U.S. Court of Appeals for the Seventh Circuit could discourage companies from making forward-looking statements that are inaccurate, materially misleading, and result in subsequent liability.[33] In that case, the shareholder plaintiffs sued a medical products manufacturer, Baxter International, Inc., for stating materially misleading stock price projections before the stock fell but after releasing second-quarter 2002 financial results.[34] The lower court held that Baxter's cautionary statements were protected by the safe-harbor provision, but the Seventh Circuit reversed holding that the cautionary statements failed to include risks the company knew would affect future results. It stated:

> The problem is not that what actually happened went unmentioned; issuers need not anticipate all sources of deviations from expectations. Rather, the problem is that there is no reason (on this record) to conclude that Baxter mentioned those sources of variance that (at the time of the projection) were the principal or important risks. For all we can tell, the major risks Baxter knew that it faced when it made its forecasts were exactly those that, according to the complaint, came to pass, yet the cautionary statement mentioned none of them. Moreover, the cautionary language remained fixed even as the risks changed.[35]

In order to invoke the safe-harbor provision, forward-looking statements must be meaningful, i.e., reflect company knowledge of those factors likely to affect future performance. Otherwise, projections may be considered inadequate if they are materially misleading but accompanied by a cautionary statement.

D. Sarbanes-Oxley Act of 2002

Since its passage in 2002, the Sarbanes-Oxley Act has affected environmental practitioners despite no mention of environmental disclosures in the text. Companies must reevaluate earlier subjective judgments of whether an environmental matter is material and warrants mention in an annual or quarterly report. Moreover, they must now monitor all environmental issues with increased vigilance to determine materiality, to implement an internal control process to identify and remediate environmental matters, to provide senior management with assessments of the environmental matters for certification of corporate reports, as well as to respond to stakeholder demands for more corporate environmental accountability. These determinations apply not only to individual companies but also their subsidiaries, parent companies, foreign partners, and companies targeted in a merger or acquisition for which their environmental liabilities are unknown.

22. *Id.* §229.303.
23. SEC, Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (2003), *available at* http://www.sec.gov/rules/interp/33-8350.htm (last visited Mar. 8, 2005) [hereinafter SEC Guidance].
24. 17 C.F.R. §229.303(a).
25. *Id.* §229.303(a)(3)(ii).
26. *Id.* §229.303(a), Instructions to Paragraph 303(a), 7.
27. SEC Guidance, *supra* note 23.
28. *Id.*
29. *Id.*
30. 17 C.F.R. §229.303, Instructions to Paragraph (b) of Item 303, 6.
31. The Private Securities Litigation Reform Act of 1995, 15 U.S.C. §§77z-2(c), 78u-5(c), 77z-2(c)(1)(A)(i).
32. SEC Guidance, *supra* note 23.
33. Asher v. Baxter Int'l, Inc., No. 03-3189 (7th Cir. July 29, 2004).
34. *Id.*, slip op. at 2 (Baxter predicted that, in 2002, the business would yield revenue growth in the "low teens" compared with growth in the "mid teens" in 2001, which the lower court determined to be a forward-looking statement).
35. *Id.*, slip op. at 13-14.

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Section 404, or Management Assessment of Internal Controls, is referred to as "among the most important parts of the Sarbanes-Oxley Act."[36] Corporate annual reports must contain a report stating that management has established and is maintaining an adequate internal control structure and procedures for financial reporting, and has assessed its effectiveness.[37] Management must evaluate the internal controls design, test the effectiveness of the implementation, and state any remediation process for compliance.[38] Auditors must state their opinion of the internal controls and verify that management has assessed the effectiveness of the report.[39] In terms of environmental reporting, companies must review current environmental liability assessment and reporting procedures. This includes a review of environmental contingencies (Item 101), environmental legal proceedings (Item 103), and material known and uncertain trends (Item 303) of the annual and quarterly reports. In reviewing its MD&A, companies must identify known as well as potentially problematic areas and a remedial process. Companies must periodically update their internal controls relating to environmental issues.

Cost has been a significant factor in implementing §404. Not only are there startup costs (with the understanding that the benefits will soon outweigh the costs), but there may also be subsequent liability costs if the internal control mechanisms do not improve a company's financial reporting. Initially, costs for implementing internal controls were estimated at $1 million in expenses per billion of revenue, but a recent study revealed that companies with average revenues of $2.5 billion spent $3.14 million for their first year of compliance, a 25% increase over the original estimate.[40] Companies with less than $2 billion in revenue spent $1.8 million per billion in revenue, an 80% increase over the original estimate.[41]

The SEC requires companies to report on the effectiveness of their internal controls by March 16, 2005. Small U.S. companies and foreign companies with U.S. offerings received a one-year extension to comply with §404's internal control provision, becoming effective July 15, 2006.[42] The extension may have been granted due to the difficulty in crafting long-term, effective internal controls, the significant financial burden placed on companies to implement the internal controls structure, and an upcoming roundtable discussion with the SEC and industry, which may offer suggestions for more effective implementation of internal controls.[43]

A review of 2004 annual reports filed with the SEC illustrates how companies are making §404 disclosures, and are approaching remediation of identified deficiencies.[44] In January 2005, 27 companies with revenue of more than $75 million disclosed material weaknesses in internal controls, versus 7 companies that made similar disclosures in January 2004.[45] Similarly, 23 companies reported some type of internal control weakness in February 2005, versus 18 such filings one year prior.[46] Material weakness in large companies result from financial systems, such as the financial close process, accounts reconciliation, or inventory processes, while small companies appear to struggle with personnel matters, such as understaffed accounting departments, poor segregation of duties, or training and supervisory problems.[47]

In its February 2005 filing, MSC.Software Corp., a business services company, stated that upon conducting an independent review, it identified material internal control weaknesses that contributed to revenue and non-revenue concerns. The deficiencies included: (1) weak oversight of internal controls; (2) insufficient independence to evaluate judgments and estimates; (3) ambiguous and inconsistent internal accounting policies and procedure; (4) inadequate monitoring and system controls in revenue data entry process; (5) insufficient documentation; and (6) insufficient skills or training in generally accepted accounting principles (GAAPs).[48] Although the filing has not appeared to affect stock value, some experts deem internal control weakness troubling since it is associated with the ethical values of management and issues of organizational integrity.[49]

Some company disclosures have shown remarkable detail in their filings. Hollinger International, a newspaper publisher, identified material weaknesses in its internal controls, including: (1) an inappropriate "tone from the top" that did not encourage a strong system of internal controls; (2) certain executive officers were not forthcoming in preparing corporate records; (3) asset extraction benefitted direct and indirect controlling stockholders; (4) certain executive officers facilitated inappropriate related party transactions; (5) management blurred the distinction of the company and its subsidiaries between individual entities and unaffiliated stockholders; (6) inadequate communication with the Audit and Compensation Committee; (7) failure to retain separate legal counsel from parent companies and controlling stockholders; (8) nonexistent internal controls; and (9) an inadequate whistleblower policy.[50]

36. Press Release, SEC, Extension of Compliance Dates for Non-Accelerated Filers and Foreign Private Issuers Regarding Internal Control Over Financial Reporting Requirements (Mar. 2, 2005) (statement of SEC Chief Accountant Donald T. Nicolaisen), *available at* http://www.sec.gov/news/press/2005-25.htm (last visited Mar. 8, 2005) [hereinafter Press Release].

37. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §404(a)(1-2), 116 Stat. 745.

38. *Id.* §404(b).

39. *Id.*

40. *SO_X 404 Disclosures: Costs Higher Than Expected*, Compliance Wk. (Mar. 5, 2005), *available at* http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=1584 (last visited Mar. 8, 2005).

41. *Id.*

42. Press Release, *supra* note 36.

43. Press Release, SEC, Commission Seeks Feedback and Announces Date of Roundtable on Implementation of Sarbanes-Oxley Internal Control Provisions (Feb, 22, 2005), *available at* http://www.sec.gov/news/press/2005-20.htm (last visited Mar. 8, 2005).

44. *January Internal Control Report: Adverse Opinions Emerge*, Compliance Wk. (Feb. 8, 2005), *available at* http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=1522 [hereinafter *January Disclosures*]. *See also Weakness, Deficiency Disclosures in February 2005*, Compliance Wk. (Mar. 8, 2005), *available at* http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=1604 (last visited Mar. 8, 2005) [hereinafter *February Disclosures*].

45. *January Disclosures*, *supra* note 44.

46. *February Disclosures*, *supra* note 44.

47. *January Disclosures*, *supra* note 44.

48. *February Disclosures*, *supra* note 44.

49. *Id.*

50. *Internal Control Disclosures in January 2005: The List*, Compliance Wk. (Feb. 8, 2005), *available at* http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=1523 (last visited Mar. 8, 2005) [hereinafter *Internal Control Disclosures*].

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Other companies have identified material weaknesses and taken disclosure one step further to include a forward-looking warning. Visteon Corporation, an auto parts manufacturer, not only concluded that certain tax adjustments led to material weaknesses in its internal controls, it also stated the expectation that its auditor "will issue an adverse opinion with respect to the company's internal controls over financial reporting, which opinion will be included in Visteon's 2004 Form 10-K."[51]

Some companies, however, merely warned of potential problems with their internal controls without providing specific examples, or remedial steps. Commercial lender CIT Group stated that a previously identified deficiency in its income tax accounting will likely be classified as a material weakness but that it "will not result in a material adjustment to the company's reported net income for [2004]."[52]

Others, which warned of potential problems, chose not to identify any material weaknesses. Energy Transfer Partners merely "identified certain internal control issues which senior management believes need to be improved."[53] While these early §404 reports may not provide methodical transparent disclosures a reasonable investor can rely on for making investment decisions, it is evident that companies are viewing disclosure of all matters as necessary for Sarbanes-Oxley Act compliance.

Once internal controls have been implemented, §302, which addresses corporate responsibility for financial reports, applies. A company's chief executive officer or chief financial officer must certify that they have reviewed the annual or quarterly report to be filed.[54] Based on their knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statement.[55] Further, the officers must "fairly present in all material respects the financial condition and results of operations of the issuer."[56] The officers report on the effectiveness of their internal controls to date,[57] disclose any significant deficiencies in the internal controls or any associated fraud,[58] and identify changes that could significantly affect the internal controls subsequent to the date of their evaluation, with corrective actions.[59]

Failure to adequately certify financial accounts or establish internal controls for accurate financial reporting can subject officers to potential civil or criminal liability under §906.[60] The statement must certify that the periodic report fairly presents, in all material respects, the financial condition and results of operation of the issuer.[61] Failure to do so will result in a fine up to $1 million, imprisonment up to 10 years, or both.[62] A willful failure to certify carries a fine of not more than $5 million, imprisonment up to 20 years, or both.[63]

III. EU Reporting Requirements

Fallout from the corporate accounting debacle has reached well beyond the United States to Europe, undermining investor confidence and corporate performance of European companies with U.S. listings or SEC-registered companies.[64] Those companies are directly affected by §106 of the Sarbanes-Oxley Act, which holds foreign auditors of SEC-registered foreign issuers subject to the Act.[65] For example, in January 2005, the U.K. retailer TM Group Holdings identified an error in accounting for property sale and operating leaseback transactions.[66] Its auditors "considered that there was insufficient knowledge and experience of U.S. GAAP in the company's corporate accounting department and [ ] considered this matter to be a reportable condition."[67] The auditors "provided an unqualified audit report on the company's financial statements for fiscal 2002 and fiscal 2003."[68] Similarly, the U.S.-based diagnostic substances group Immucor "identified certain weaknesses in internal control in the Italian subsidiary" and the company "has undertaken a thorough review of the books and records of the Italian subsidiary with the assistance for forensic audit personnel."[69] Europe responded by passing the EU Directive, and the United Kingdom responded with the Companies Act 1985, Regulation 2005, and the OFR requirement, all of which come into effect in 2005. These new regulations emphasize reporting of non-financial performance indicators, which include environmental, labor, and social issues.

A. The EU Directive

In 2001, the European Commission determined that it lacked "harmonised authoritative guidelines in relation to environmental issues and financial reporting,"[70] and that voluntary corporate environmental disclosure was "running at low levels."[71] The disparity of different rules for different stakeholders contravened the EU move toward consistency between financial reporting by Member States, international accounting standards, and single market policies.[72]

51. *Id.*
52. *January Disclosures*, *supra* note 44.
53. *Id.*
54. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §302(a)(1), 116 Stat. 745.
55. *Id.* §302(a)(2).
56. *Id.* §302(a)(3).
57. *Id.* §302(a)(4).
58. *Id.* §302(a)(5).
59. *Id.* §302(a)(6).
60. *Id.* §906.
61. *Id.* §906(b).
62. *Id.* §906(c)(1).
63. *Id.* §906(c)(2).
64. Section 2(a)(7) defines issuers, including foreign issuers, as any person or company who issues or proposes to issue its securities to the U.S. public or has registered securities under the U.S. Securities Exchange Act of 1934. Some foreign issuers, including companies from EU Member States and the United Kingdom, are currently lobbying the SEC to ease its disclosure rules, while other companies are considering delisting and deregistering to avoid incurring compliance costs associated with strengthening internal controls and external auditing certification.
65. Section 106 defines a foreign public accounting firm as "a public accounting firm that is organized and operates under the laws of a foreign government or political subdivision thereof." *Id.* §106(d).
66. *Internal Control Disclosures*, *supra* note 50.
67. *Id.*
68. *Id.*
69. *January Disclosures*, *supra* note 44.
70. Commission Recommendation 2001/453/EC of 30 May 2001 on the Recognition, Measurement, and Disclosure of Environmental Issues in the Annual Accounts and Annual Reports of Companies, 2001 O.J. (L 156) 33.
71. *Id.*
72. *See id.*

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The commission recommended clarifying existing rules and providing more specific guidance on recognition, measurement, and disclosure of environmental issues in annual reports,[73] which led to the EU Directive.

Effective January 1, 2005,[74] the EU Directive moves the EU closer to a single capital market by formalizing individual Member States' accounting practices with a more modern, unified set of international accounting standards.[75] Similar to the U.S. MD&A requirement, EU-listed companies[76] must include a comprehensive analysis of its performance in the annual reports and consolidated accounts, including non-financial information to the extent it provides a balanced picture of the company's position.[77] Section 9 states that the annual report, in presenting a "fair review" of the company's financial condition, should include "an analysis of environmental and social aspects necessary for an understanding of the company's development, performance, or position" consistent with the 2001 recommendations.[78] Company directors must exercise due care to verify the analysis of the company's performance, and auditors must state that the report gives a "true and fair view in accordance with the relevant financial reporting framework" and clarifies the context for the auditors' opinion.[79]

The EU Directive allows Member States to waive the burden of providing non-financial information due to the "evolving nature of this area of financial reporting" and to implement the regulation through their own legislation.[80] One of the most complete local implementations of the EU Directive is the U.K. Companies Act revisions and its new OFR requirement.

B. U.K. Companies Act and the OFR Requirement

While the EU was reforming earlier directives on the annual and consolidated accounts of companies, banks, and other financial institutions and insurance undertakings, the United Kingdom was modernizing the Companies Act 1985, which created new requirements for quoted companies.[81] It also enhanced the existing directors' report requirements for unquoted large and medium companies.[82]

As of April 1, 2005, directors of quoted U.K. companies will be required to prepare an OFR for inclusion in their annual report, similar to the MD&A.[83] The law also requires auditors to review OFRs and it establishes criminal and administrative penalties for failure to submit OFRs.[84] Similar to the U.S. regulations, the purpose of the OFR is to provide stakeholders with a balanced and comprehensive analysis of the company's current performance and main trends, which are likely to affect its future performance, upon which to make informed investment decisions.[85] Inclusion of corporate governance issues such as environmental matters is encouraged, and issues should be included "to the extent necessary" for directors to provide the company analysis to shareholders.[86] If the company determines that there are no environmental matters that contribute to the analysis, the directors are still required to make a positive statement as to which of the issues the statement applies.[87] However, auditors will evaluate this decision upon "due and careful" inquiry, and determine consistency with the corporate accounts.[88] The auditors must report any inconsistencies between their review and the submitted OFR, which will be published in the annual report.[89] The OFR requirement, and the possibility for penalties, are expected to increase environmental disclosure significantly.[90]

Similar to the forward-looking statements required under U.S. requirements,[91] the OFR must include information about the company's future plans and prospects, specifically "main trends and factors that are likely to affect the company's future development, performance, and position."[92] Unlike the U.S. requirements, however, the OFR provides no safe-harbor provision protecting directors from making statements about anticipated events that do not occur. In fact, no information about impending developments or matters in the course of negotiation needs to be disclosed if it would, in the opinion of the directors, seriously prejudice the company's interests.[93] The explanatory memoranda caution that when forward-looking statements are made in good faith but cannot be verified, directors may want to advise readers to treat the information with caution.[94] The Companies Act also requires that directors exercise due care, skill, and diligence in preparing the OFR; breach of OFR requirements may lead to criminal penalties for OFRs filed after April 1, 2005, or civil penalties for OFRs filed after April

73. *See id.*
74. The EU Directive was passed June 18, 2003, but implemented January 1, 2005.
75. EU Directive §3 states that International Accounting Standards (IAS) Regulation (1606/2002), dated July 19, 2002, will require listed companies, including banks and insurance companies, to prepare their consolidated accounts in accordance with IAS from 2005 onwards. *See* European Financial Reporting Advisory Group (EFRAG) homepage *at* http://www.efrag.org/ (last visited Mar. 8, 2002).
76. EU Directive §1 defines listed companies as "[c]ommunity companies whose securities are admitted to trading on a regulated market."
77. EU Directive, *supra* note 2, §9.
78. *Id.*
79. *Id.* §10.
80. *Id.* §9.
81. Companies can be "quoted" on an interdealer quotation system or "listed" on a stock exchange, but are held to different disclosure standards. Quoted companies will be required to submit an OFR once the Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 becomes effective.
82. Unquoted companies will still be required to submit a directors' report (different from an OFR) but under stricter standards.
83. *See* Explanatory Memorandum to the Draft of the Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 (2005), *available at* http://www.legislation.hmso.gov.uk/si/si2005/draft/20051592.htm (last visited Mar. 8, 2005) [hereinafter Explanatory Memo].
84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.*
90. The annual accounts are *audited* whereas the annual report is *reviewed for inconsistencies* with the accounts; *see* U.K. Environmental Agency, Environmental Disclosures in the Annual Report and Accounts of Companies in the FTSE All Share 37 (2004), *available at* http://www.environment-agency.gov.uk (last visited Mar. 14, 2005) [hereinafter Environmental Disclosures].
91. *Infra* note 26.
92. *See* Explanatory Memo, *supra* note 83.
93. *See* Draft U.K. Companies Act, *supra* note 3, pt. 3.
94. *See* Explanatory Memo, *supra* note 83.

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1, 2006.[95] Finally, the Financial Reporting Review Panel (FRRP) and Secretary of State will enforce the regulations, and inquire about an OFR if it "appears factually wrong in a material respect" or it "contains an opinion no reasonable board could have formed if it had followed a proper process of collective and evaluating evidence."[96] In short, the FRRP has the legal authority to review the company directors' report and, if necessary, go to court to compel the company to revise its report.

The OFR requirement complements the EU Directive's requirements for more disclosure in that it allows U.K. companies to prepare and submit only OFRs to comply with the EU Directive; there is no longer a need to prepare a separate directors' report.[97] As such, the United Kingdom has delayed implementing the EU Directive in the United Kingdom until April 1, 2005.

In contrast to the stringent disclosure requirements for quoted companies to prepare OFRs, directors of unquoted large and medium companies are required to submit the traditional directors' report, which has undergone minor changes under recent regulations promulgated under the Companies Act 1985.[98] The directors' report must contain an expanded fair review of their business, similar to what is required in the OFR.[99] The main difference, however, is that the unquoted businesses do not need to report on trends and factors affecting the company's future development. The OFR "is more forward-looking in nature and includes information on the strategies and policies the company is deploying for long term success."[100] However, directors' reports still must include environmental matters "to the extent necessary" to understand the company's performance, and penalties are parallel to the OFR. Auditors' OFR duties also parallel directors' reports in that they must state that, in their opinion, the information in the reports are consistent with the company's accounts.[101]

While the OFR requirements and the EU Directive require much of the same attention to environmental disclosures as the MD&A under U.S. law, it is too soon to determine whether they will, in fact, result in more transparency for publicly listed companies.

IV. Why Disclosure Remains Inadequate

Corporate reporting of environmental disclosures remains inadequate despite new, tougher regulations. The new regulations are unclear as to what to report, and the SEC does not have a system to monitor and enforce its own environmental disclosure regulations. Beyond enforcement, however, the typical corporation does not see the value of reporting environmental issues to create long-term company and shareholder value. In other words, there exists no corporate culture to link environmental performance to financial performance.

The U.S. Government Accountability Office (GAO) highlighted this disconnect in a July 2004 U.S. Senate-commissioned study on corporate environmental disclosures after the enactment of the Sarbanes-Oxley Act.[102] The Senate asked the GAO to survey a range of experts on the effectiveness of the SEC's efforts to define, monitor, and enforce environmental disclosure. Company response was that the requirements were sufficient and that "requiring additional information would not improve investor's ability to make sound investment decisions."[103] They stated: (1) corporate environmental performance is disclosed in press releases or reports separate from SEC filings; (2) environmental information is less important than other types of information, such as executive compensation or board stock ownership; (3) more disclosure without assurance that the information is material would "not add value and might burden readers [with] irrelevant data"; (4) SEC disclosure requirements do not drive compliance as much as environmental regulations and market forces; and (5) aggregating similar environmental liabilities "might distort the actual risks a company faces."[104] Moreover, businesses "opposed requiring more disclosure of future risks, such as the estimated costs associated with potential environmental regulations, because of the degree of uncertainty about the impact on companies' financial condition and operations."[105] Conversely, socially responsible investor groups, researchers, and environmental nonprofits felt the requirements are "too narrowly scoped in some areas to ensure that companies are making available all of the important environmental information needed by investors."[106]

In reviewing the SEC's methodology, the GAO could not determine the extent to which companies are disclosing environmental information in their annual and quarterly reports. The SEC reviews only about 8 to 20% of the filings each year (from 1999-2003), and does not track its comments on filings to determine trends.[107] That is, it does not maintain a database on the substance of its comments and company responses.[108] Consequently, the GAO could not determine the effectiveness of the SEC's monitoring and enforcement efforts with regard to environmental disclosures. The report recommended that the SEC should track comments on filings to uncover common problems on which to issue guidance, create a public database for SEC comment letters, and have more formal coordination with EPA.[109] The SEC responded to GAO's recommendations and is in the process of implementing an electronic database to analyze SEC reviews of public company filings, as well as creating a searchable database of SEC comment letters and company responses.[110]

95. *Id.*

96. *Id.*

97. *See* Simmons & Simmons, *Accounting Modernisation Directive Summary, at* http://www.elexica.com/fsap/account/account3.htm (last visited Mar. 8, 2005) [hereinafter *Directive Summary*].

98. Draft U.K. Companies Act, *supra* note 3.

99. *See Directive Summary, supra* note 97.

100. *See id.*

101. *Id.*

102. U.S. GAO, Environmental Disclosure: SEC Should Explore Ways to Improve Tracking and Transparency of Information (2004) (GAO 04-0808), *available at* http://www.gao.gov/new.items/d04808.pdf (last visited Mar. 8, 2005).

103. *Id.* at 14.

104. *Id.* at 15.

105. *Id.*

106. *Id.* at 13.

107. *Id.* at 23-26.

108. *Id.* at 23.

109. *Id.* at 36-37.

110. Letter from William H. Donaldson, Chairman, SEC, to the Honorable Ted Stevens, Chairman, Committee on Appropriations (Oct. 5, 2004).

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A 2004 study by the U.K. Environment Agency[111] on environmental disclosures found that while 89% of Financial Times Stock Exchange (FTSE) All Share companies discussed the environment in annual reports, the majority did not conduct the depth of analysis that will be required by the OFR.[112] Most FTSE All Share reporting of environmental interactions "lack depth, rigour, or quantification and 11% disclose nothing at all."[113] Only 12% of FTSE All Share companies consider environmental matters as financially material to contribute to shareholder value.[114] The report commented directly on the failure of companies to link environmental disclosures with financial performance, stating "this lack of a direct link is disappointing. Many shareholders will be left querying the significance of environmental issues to the bottom line and consequently ignore them, unless the link is made more explicit."[115]

Similar to the U.S. corporate culture, it is likely that U.K. companies have also traditionally focused on the bottom line to the exclusion of non-financial drivers in financial statements. So long as "[t]he responsibility of a business is to make as much money as possible,"[116] environmental matters will be marginalized, thereby reinforcing the idea that environmental matters do not contribute to profits and losses.

V. Conclusion

Since the passage of the Sarbanes-Oxley Act, companies have had to implement and strengthen existing internal controls to provide to investors all relevant information necessary for complete accounting and disclosure. The corporate environmental community continues to pay close attention to disclosure requirements, which obligate reporting of hazardous waste cleanups, penalties associated with EPA regulations, the costs of retrofitting polluting facilities, and other environmental matters. However, the Act's emphasis on disclosing not just past remedial actions but also forward-looking, anticipated environmental liabilities and risks, such as the effects of climate change, or proposed laws and treaties yet to be enacted, provide a challenge to environmental practitioners, corporate management, auditors, and regulators. The new business laws contemplated by the EU and the United Kingdom appear to require significant accountability and reporting by boards of directors. Time will tell whether these new reporting requirements will positively affect transparency and corporate accountability. After all, the current U.S. reporting requirements are complex, hard to interpret, and continue to evolve. In the meantime, there remains a need for the SEC to provide more guidance and oversight of environmental reporting requirements to companies, which are under pressure from some stakeholders to make full disclosures. This might include more SEC review of company filings, or coordination with federal and state environmental agencies, as suggested by the GAO report. EPA already collects information on environmental remediation liabilities, which the SEC could use to evaluate whether companies are reporting adequately. Furthermore, there is a need for continued reinforcement of the belief that stakeholders are interested in eliciting information from companies about their environmental risks and liabilities. Admittedly, it is difficult to establish a connection between financial and environmental performance without more quantification of environmental costs. However, investors and analysts understand that a well-governed company is one that pays attention to environmental management since environmental risks affect a company's ability to create long-term value. Company value could decrease as a result of environmental liabilities and, therefore, access to adequate environmental information is vital for sound business decisionmaking. Once companies regularly include environmental costs in their required financial disclosures, stakeholders can evaluate the materiality of the liabilities on a consistent basis. Adequate environmental disclosure, then, is imperative for improving corporate governance and accountability, and reinstating investor confidence in markets.

111. Environmental Disclosures, *supra* note 90.

112. *Id.* at 4.

113. *Id.*

114. *Id.* at 9.

115. *Id.*

116. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times, Sept. 13, 1971 (Magazine), at 33.