

Environmental Disclosure Committee Newsletter

Vol. 10, No. 1

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MEMBERSHIP VICE CHAIR NOTE

Peter J. Gioello Jr.

As your new vice chair for Membership, I wanted to take this opportunity to introduce myself and to let everyone know that they should feel free to reach out to me with any comments or suggestions having to do in any way with the Environmental Disclosure Committee.

At this time, we have 259 committee members located in 36 states and Puerto Rico. Our membership list includes several students, attorneys in private law firms, government attorneys, public interest attorneys and in-house counsel at companies in various sectors, including but not limited to the insurance, finance, oil and gas, energy, food, retail, and environmental engineering sectors. We hope that we are able to attract new members in the upcoming year—please do your part and tell friends and colleagues about our committee.

At the recent Section meeting in Austin, committee members connected with one another and discussed potential programming for the upcoming year. Outside of the section events, we are hoping that members are able to connect with one another throughout the year as well. For example, attorneys in a particular industry or geographic region may wish to come together and organize some sort of event or draft a timely article. As in past years, we are welcome to ideas and

suggestions—just send them through me or to another one of the committee leaders.

We will be sure to keep everyone posted about upcoming events. In the meantime, please let me know if you would like to become more involved or if you have any programming suggestions or ideas for news articles in the next year. Have a safe and happy holiday season!

Peter Gioello is an associate at Cahill Gordon & Reindel LLP in the Environmental Practice Group focusing principally on environmental risks in connection with corporate transactions. He is vice chair of Membership for the Environmental Disclosure Committee for the ABA Section of Environment, Energy, and Resources and is a member of the Environmental Law Committee for the New York City Bar Association.

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Environmental Disclosure
Committee Newsletter
Vol. 10, No. 1, December 2012
David A. Roth, Editor

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**AMERICAN BAR ASSOCIATION
SECTION OF ENVIRONMENT,
ENERGY, AND RESOURCES**

CALENDAR OF SECTION EVENTS

January 25-27, 2013
ABA SEER Winter Council Meeting
La Concha Resort
San Juan, PR

February 6-12, 2013
ABA Midyear Meeting
Dallas, TX

February 26, 2013
**Key Environmental Issues in US EPA
Region 4**
Atlanta, GA

March 21-23, 2013
42nd Spring Conference
Grand America Hotel
Salt Lake City, UT

April 11-12, 2013
**ABA Petroleum Marketing Attorneys'
Meeting**
Washington, DC

April 18, 2013
**ABA Public Lands and Resources Law
Symposium**
Missoula, MT

April 19-21, 2013
ABA SEER Spring Council Meeting
Greenough, MT

June 5-7, 2013
31st Annual Water Law Conference
Las Vegas, NV

**For full details, please visit
www.ambar.org/EnvironCalendar**

DEFENSIBLE COST ESTIMATING FUNDAMENTALS IN THE CONTEXT OF ENVIRONMENTAL DISCLOSURE

Michael Berman and Paul Brookner

Reporting entities in the United States, along with their legal and financial counsel, are generally well acquainted with the requirements associated with the disclosure, quantification, and reporting of environmental liabilities. Traditionally some reporting entities may have assumed that environmental liabilities were not material to their overall financial bottom lines. However, over the past decade of the post–Sarbanes-Oxley era, a focus on the quantification of contingent environmental liabilities has become more prominent. That is, the need to specifically quantify the magnitude of costs associated with an environmental liability has been required or requested more and more frequently.

This task of quantification has always been complicated by the inherent uncertainty in estimating an unknown (such as, what might have happened underground decades ago), often based on limited data and information, as well as the highly site-specific aspects of many environmental liabilities. For example, a similar historic industrial practice in one location may have resulted in minimal impact—but in another location may have resulted in significant environmental liabilities. The task of appropriately valuing environmental liabilities is made more complex in the face of changing financial accounting regulations (such as those focused on contingent asset retirement obligations and disclosure of liabilities associated with greenhouse gases); prudent business practices in the context of increasing corporate cash flow concerns and bankruptcies; pressure from shareholders to provide corporate transparency, and ongoing litigation risks.

It is our observation that systems and approaches used to comply with the environmental liability valuation (or “ELV”) aspect of financial reporting requirements vary widely from entity to entity, as appropriate for the respective nature of their environmental liability portfolios. However, we have observed some fundamental principles and similarities, as well as some emerging trends, in how many entities are quantifying their environmental liabilities. This article provides an

overview of these core approaches and trends in the context of our experience supporting clients in broad aspects of ELV and financial reporting.

ELV in the Framework of Disclosure

In general terms, ELV can be defined as an estimate used *for a specific purpose* to *quantify the cost* to address an *environmental condition*. This basic definition is broadly applicable. However, each ELV analysis needs to be done in the context of how the terms “specific purpose,” “quantify,” and “environmental condition” are applied by the prevailing requirements and various stakeholders in the estimate that is being conducted. As such, an ELV analysis of the same “environmental condition” could result in a very different value, when applied under different circumstances.

The example of a large leaking underground storage tank can be considered. It may be known that an underground tank has been leaking (perhaps through leak detection monitoring or inventory loss documentation). But, at least initially, the magnitude of the environmental impact is generally not known and, as a result, there is a broad range of costs that may be incurred to ultimately address the issue. An environmental expert may be asked to value this liability and the result of such an analysis may be different, depending on the purpose of the analysis. For example:

- A short-term **budgeting** analysis may only focus on the costs that are expected in an immediate future time frame (e.g., the current or next financial period).
- An analysis in support of a feasibility study for a Superfund site will typically seek to provide an estimate consistent with the U.S. Environmental Protection Agency (EPA) costing guidance (e.g., using a specified discount rate and within an uncertainty range of +50/-30 percent).
- An analysis to support an **insurance claim** may focus on costs that are recoverable under the available coverage (e.g., considering only costs associated with an occurrence during a coverage period).

- An analysis in support of a **merger, divestiture, or acquisition** or a **legal dispute** over environmental liability may seek to determine a risk-weighted expected value of the liability—or, alternately, may not focus on the value of this liability at all if it is below a certain cost threshold.
- An ELV analysis in support of **financial disclosure** decision making in the Federal Accounting Standards Board (FASB) and the U.S. Securities and Exchange Commission (SEC) framework will necessarily focus on costs that are required under the relevant standards and regulations (e.g., costs associated with a contingent loss will focus on the costs that are “probable and reasonably estimable”).

While the specific requirements associated with the disclosure and reporting of environmental liabilities are beyond the scope of this article, environmental liabilities generally fall into one of the following categories:

- **Contingent Loss**—Addressed under Accounting Standard Codification (ASC) 450 (Contingencies) (Former FAS 5);
- **Asset Retirement Obligation (ARO)**—Addressed under ASC 410 (Asset Retirement and Environmental Obligations); or
- **Contingent ARO**—Addressed under both ASC 410 and ASC 450.

Common ELV Guidance

Within the framework of various financial reporting standards, environmental professionals most typically look to certain guidance documents to provide a defensible foundation for environmental cost estimates. While there is no “right way” to complete an environmental liability evaluation, a host of guidance documents is available, several of which are listed at the end of this article. These guidance documents include those published by EPA, the U.S. Department of Defense, U.S. Department of Energy, and other nongovernmental industry groups, such as the Association for the Advancement of Cost Estimation (AACE).

Another relevant guidance document worth mentioning is the ASTM’s E2173-07 (2011) Standard Guide for Disclosure of Environmental Liabilities. ASTM provides this guidance as an overview for the strategy and decision-making framework required to determine which environmental liabilities require disclosure and describes the reporting requirements that are relevant to such disclosure. This document does not address how estimates of environmental liability can or should be made.

One of the more frequently referenced guidance documents generally used by environmental experts is the ASTM E2137-06 (2011), Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters. First published in 2001, this standard was revised in 2006 and reauthorized in 2011. While ASTM E2137 does not provide a “cookbook” approach to ELV, it does provide a solid framework and fundamental basis for completing analyses in a variety of contexts—including in support of environmental liability disclosure and reporting.

ASTM E2137 describes a suite of fundamental components that should be considered in developing any environmental cost estimate. These components can be summarized as follows:

- understanding the information to be used
- understanding costs and liabilities to be included/excluded
- determining the appropriate estimation approach
- understanding and quantifying the appropriate uncertainty
- considering contingencies
- considering net present value (NPV)
- considering allocation, offsets, and recoveries

All of these steps are vital to conducting and being able to defend any environmental cost estimate. Several of the key aspects are discussed below.

Choice of Estimation Approach—Statistical Basis

At its heart, the decision of how to approach a cost estimate is grounded in statistics. Since there is inherent

uncertainty in the prediction of future costs, a range of potential outcomes must be considered. In an example, a hypothetical cost distribution showing the potential Cost of Outcome along the bottom (x-axis) (as represented with associated percentiles) and the Likelihood of Occurrence on the left (y-axis) is presented as exhibit 1.



Exhibit 1: Hypothetical Cost Distribution

The shape of this hypothetical case resembles a log-normal distribution, which is sometimes used to represent cost uncertainty where it is more likely that the cost has been underestimated rather than overestimated. The arrows above the curve show statistically defined points along the cost spectrum. These points also are consistent with certain defined costing approaches described in ASTM E2137-06 (2011)—the mode, median, and mean of the dataset shown represent the Most Likely, More Likely than Not, and Expected values, respectively. The arrows at the bottom correspond to definitions used in various U.S. accounting disclosure standards. These definitions are not mathematically quantified, but are rather defined in accordance with a reporting entity’s audited management system. In addition to determining the appropriate ranges defining terms such as Possible, Probable, and Remote, a reporting entity must also consider and define how concepts such as “reasonably estimable” and “material” apply to its environmental liabilities.

Choice of Estimation Approach—Implementation

The core concepts of determining the appropriate estimation approach and understanding and addressing the appropriate level of uncertainty go hand in hand as illustrated in the following diagram—as based on a

hierarchy of costing approaches described in ASTM E2137-06 (2011) and shown in exhibit 2.

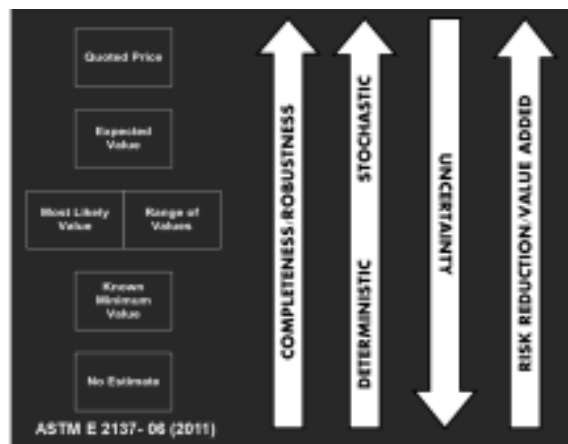


Exhibit 2: Hierarchy of Costing Approaches

Cost estimating approaches range from “No Estimate” (which in some cases may be a prudent option) to the gold standard of obtaining a Quoted Price—essentially an offer from an informed and willing market participant to take the liability—such as via an insurance product or a guaranteed fixed-price remediation offer. As the estimates progress from the bottom to the top of the hierarchy, the estimating approach becomes more complete and robust, uncertainty is better addressed, and the estimates provide greater risk reduction and value added to the user. The more complete/robust methodologies also generally require more information in order to adequately prepare the estimates.

Traditionally, estimates used to support environmental reserves for financial reporting are typically accomplished using the Most Likely Value approach, to determine the cost of what is believed to be the cost of the most probable outcome. In cases where the ranges of outcomes are all equally probable, FASB financial reporting requirements allow (ASC 40-20—Reasonable Estimation of the Amount of a Loss) the entry to report the low end of the range—often estimated using the Known Minimum Value approach.

In certain cases, more robust estimates of environmental liabilities are required. For example, requirements for valuation of contingent losses in the

context of business combinations (ASC 805) require the estimation of such costs at their Fair Value (potentially represented via a Quoted Price or Expected Value). The disclosure of “Pollution Remediation Obligations” by state and municipal government entities (Government Accounting Standard Board Financial Accounting Foundation 49) requires the reporting of the Expected Value of such liabilities. In addition, parallel requirements that apply to the quantification of environmental liabilities in the context of International Financial Accounting Standards (IFAS) also require a more robust quantification of environmental liabilities using either an Expected Value approach or a mid-point of a Range of Values (International Accounting Standard 37—Provisions, Contingent Liabilities and Contingent Assets).

Inherently, the most complex estimating approaches require greater knowledge and experience from the estimator, and more sophisticated tools for completion. For example, a single point estimate, such as a Known Minimum Value, can be prepared with a simple spreadsheet or from an existing consultant estimate. More complex multi-point estimates, such as Expected Values, necessitate more complex tools such as spreadsheet models that incorporate stochastic simulation methods, such as Monte Carlo analysis via specialized software tools (e.g., Palisade’s *@Risk* or Oracle’s *Crystal Ball*).

All of these estimation techniques can draw unit costs from a variety of sources ranging from institutional/consultant expert knowledge to published sources like unit cost books (e.g., those published by R.S. Means) or unit costs compiled and made available by government agencies. There are also a number of software packages available that are intended specifically for environmental cost estimating, such as *RACER* (AECOM) and *CostPro* (EPA).

Items Included/Excluded

An estimate must consider and define what costs and liabilities are to be included and excluded. For the purpose of a cost estimate in support of financial reporting, different categories of costs/liabilities are often created for reporting under different reporting

requirements. For example, liabilities associated with remediation obligations from legacy or Superfund liabilities are typically handled as contingent losses (ASC 450), whereas closure or decommissioning requirements, either expected from the start or arising unexpectedly, are typically addressed as AROs (contingent or otherwise). As discussed above, these different categories of costs may require estimation and reporting in different ways. The inclusion of costs in an inappropriate category can have ramifications in the acceptability of the reported costs by auditors, as well as have cascading effects on other business considerations such as insurance coverage and potential recoverability of costs under the Comprehensive Environmental Response, Compensation, and Liability Act.

Uncertainty

Any estimate that attempts to predict the future has inherent uncertainty, and variables like scientific interpretation, evolution of technology, regulatory enforcement, and public opinion only broaden the range of possible cost outcomes. Therefore, any estimation approach must be developed and implemented with an understanding of the acceptable level of uncertainty. In the case of ELV in support of financial reporting, uncertainty is acknowledged and allowed within the regulatory framework. However, reporting entities are required to disclose instances where uncertainty may represent contingent losses that may be material. Some reporting entities address this by developing more robust estimates, such as Expected Values, which—by definition—incorporate the likelihood and magnitude of a range of possible outcomes and costs. Other reporting entities provide a second, reasonable worst-case cost (essentially an upper end of a Range of Cost approach) for certain significant liabilities.

Source of Unit Costs

Any consultant or expert preparing a defensible cost estimate will need unit costs or cost components to build ELV. In general, the available categories of costs are as follows:

- actual site-specific costs from existing documentation (e.g., from consultants familiar with the liability)
- known costs associated with similar liabilities (e.g., from other sites or from published data)
- vendor quotes for certain cost components (e.g., disposal costs)
- generated costs from standard sources (e.g., RACER, Means, CostEst)
- general estimator experience

The costs at the top of this list are easiest to defend and any estimate obtained from a separate source may need to be validated and/or adjusted to normalize factors such as for geography or timing of the costs. Regardless of the unit costing source employed, the source should be documented and if multiple sources are relied upon, a clear hierarchy (such as the one above) should be established to support an estimate that is defensible and does not raise a question about the estimator biasing the underlying costs.

Contingency

While there is a distinction between uncertainty and contingency, it is a reality that many practitioners account for upper-end uncertainty in cost estimates by employing a contingency factor. However, if and how a contingency is applied and what magnitude contingency is used vary widely from entity to entity and often from estimate to estimate. One reason for this is the very broad range of guidance provided on this subject. For example, EPA's 2000 guidance, *A Guide to Developing and Documenting Cost Estimates During the Feasibility Study*, provides general guidance for both scope and cost contingency, resulting in a contingency range of 15 to 55 percent. The U.S. Department of Energy also provides guidance (G430.1-1) with an even wider acceptable contingency range—15 to 100 percent for planning phases and up to 50 percent for remediation phases. The AACE similarly has published a broad range of 10 to 80 percent for potentially appropriate contingency to use on environmental projects. Neither ASTM nor FASB provides specific guidance on the application of contingency for environmental liability estimates. Therefore, the use of contingency, while appropriate in

many cases, should be applied with a full understanding and consideration of appropriate guidance and the specifics of the site—and should be applied in a consistent manner.

Discounting Future Cash Flows

In general, FASB only allows for discounting of future cash flows for the purpose of reporting contingent losses associated with environmental liabilities when the amount of the recurring liability and the timing of the payments are fixed or reliably determined. However, the effect of discounting can be significant and discounting is appropriate (or in some cases required) for other types of estimates. Exhibit 3 shows the significant effect that can result from the use of different real discount rates. It shows the cumulative net present value of a \$1 per year payment over 100 years.

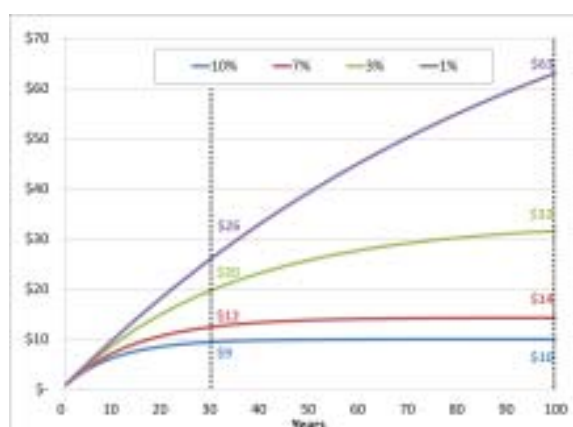


Exhibit 3: Effect of Varying Real Discount Rate on NPV

It is notable that the difference between using a 1 percent discount rate (generally consistent with recent “risk-free” rates) and a 7 percent discount rate (specified by EPA for use in Feasibility Studies for Superfund Sites) results in a twofold difference in net present value after 30 years and a fourfold difference in net present value after 100 years.

Amongst various stakeholders—including environmental consultants—there is a wide range of understanding the concept of discounting. For example, the basic and fundamental concept of what is a Real discount rate (a rate used to discount constant

dollar cash flows) versus a Nominal discount rate (a rate used to discount inflated future cash flows) is not widely understood.

For these reasons, it is important that discounting and an appropriate discount rate be considered and applied carefully. It is notable that, in accordance with EPA guidance, the use of a 7 percent discount rate is widely used today. However, this convention was established to allow for the comparison of different estimates and it has not been updated to reflect the changes in actual economic reality.

Future Trends

In the years since Sarbanes-Oxley in 2002, there have been incremental changes to the manner in which entities must report their environmental liabilities. FASB Interpretation Notice No. 47 in 2005 solidified requirements associated with accounting for conditional AROs. In 2007, the revised FASB Statement No. 141 clarified reporting requirements associated with “business combinations,” including that loss contingencies must be reported at their fair value when possible. FASB progressed to two Exposure Drafts on its project to consider expanding loss contingency disclosure and reporting requirements under ASC 450. However, in 2012, FASB voted to end this project and not accept changes considered in the Exposure Drafts.

The framework for financial reporting in the United States appears to have stabilized for the time being. However, some reporting entities are moving to more robust approaches for valuing their environmental liabilities. As discussed earlier, reasons for this move range from business combinations to international accounting standard drivers to more macro-level drivers for better measurement and corporate transparency. As a result, we have observed the following trends and changes in the way that environmental consultants are asked to support financial reporting processes:

- more robust estimate approaches, such as Expected Value estimates that reflect multiple cost outcomes

- estimates being accomplished by environmental experts or consultants with input from reporting entities, legal, accounting, and risk management personnel
- estimates that consider assets and liabilities together and that include a broader range of liabilities, such those associated with carbon emissions and other life-cycle cost considerations
- the general application of more advanced financial analytical tools, such as tail risk analysis, real options valuation, synthetic fair value, and customized discounting strategies, to assess environmental liability

Reporting entities should continue to be attentive to the current state of the practice in environmental liability cost estimation. In some cases, more thorough analysis may be required to comply with applicable standards. In all cases, more thorough analysis can yield more accurate and defensible estimates and potentially justify lower environmental reserve accruals.

Useful References

The following references provide additional information relevant to ELV and may be helpful in considering approaches and methodologies to estimate environmental liabilities in the context of financial reporting requirements:

- AACE. *Total Cost Management Framework*. Accessible at <http://www.aacei.org/resources/tcm>.
- American Institute of Certified Public Accountants, Inc. 1996. ACC Section 10,680, *Statement of Position 96-1 Environmental Remediation Liabilities*, October 10.
- ASTM International. 2011. E2173-07 (2011), *Standard Guide for Disclosure of Environmental Liabilities*. Available for purchase from ASTM at <http://www.astm.org/Standards/E2173.htm>.
- ASTM International. 2011. E2137-06 (2011), *Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters*. Available for purchase from ASTM at <http://www.astm.org/Standards/E2137.htm>.

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- International Accounting Standards Board. 2012. *Technical Summary on International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets*. <http://www.ifrs.org/IFRSs/Documents/English%20IAS%20and%20IFRS%20PDFs%202012/IAS%2037.pdf>.
- USEPA. 2000. *A Guide to Developing and Documenting Cost Estimates During the Feasibility Study*. EPA 540-R-00-002, OSWER 9355.0-75. July. Available at <http://www.epa.gov/superfund/policy/remedy/sfremedy/rifs/costest.htm>.
- U.S. Department of Defense. 2006. *Environmental Liabilities Best Practices Guide*. May. Available at http://www.acq.osd.mil/pepolicy/pdfs/Environmental%20Liabilities%20Best%20Practices%20Guide_Final.pdf.
- U.S. Department of Energy. *Guidance 430.1 Series*. Relevant chapters available at <https://www.directives.doe.gov/directives/current-directives/directives-current-400-series>.

Michael Berman and **Paul Brookner** are senior practitioners with Geosyntec Consultants. They provide expert support to legal, industry, and government clients on projects involving the evaluation, quantification, and mitigation of environmental remediation liabilities. They can be reached at mberman@geosyntec.com and pbrookner@geosyntec.com, respectively.

WATER-RELATED RISKS AND OPPORTUNITIES UPDATE

E. Lynn Grayson
Jenner & Block

In late November 2012, major U.S. newspapers carried headlines about a possible halt of barge traffic on the Mississippi River resulting from a significant drop in water levels caused by this year’s drought conditions. Barges already are required to carry lighter loads due to historic river lows between St. Louis, Missouri, and Cairo, Illinois. Governors of states along the Mississippi River, members of Congress, and river shipping trade groups have asked President Obama to intervene in managing water flows from tributary waterways to avoid “disastrous economic consequences . . .” for barge operators and those who ship on the Mississippi River.

News about water-related problems is on the rise as are growing concerns about how to manage water needs now and in the future. Many believe that water scarcity may be emerging as the most significant consequence of climate change. In August 2012, an ORC International report for the Civil Society Institute, *Drought, Water and Energy—A National Survey of Attitudes*, provided some interesting insights into how Americans viewed water concerns:

- Americans are worried about drought and want to see clean drinking water get a higher national priority.
- Two-thirds of Americans now think climate change is “real” or “appears to be happening.”
- Four out of five Americans are concerned about increased drought, wildfires, and extreme weather events.
- Nearly two-thirds of Americans are very concerned about possible shortages of safe drinking water.
- Four out of five Americans believe the availability of ample clean water should be a top national priority for the United States.

- Two in five Americans have personally experienced the impact of drought in the last year.

Water risks also pose critical concerns for U.S. businesses and their investors. In response to these potential risks, the CEOs of 45 U.S. companies recently joined the United Nations (UN) Global Compact committing to improve water management practices worldwide. The UN has estimated:

- Eight hundred million people worldwide don't have safe drinking water.
- Two-and-one-half billion lack access to sanitation.
- Water demand will outstrip supply by 40 percent by 2030.

By joining the UN Global Compact, the CEOs agreed to work more actively with governments and public authorities in responsible and transparent ways to help solve the global water crisis.

Water stress considerations may present a material liability for some companies requiring SEC disclosure. Water challenges, SEC disclosures, and growing emphasis on voluntary disclosures to safeguard investors were the subject of a September 12 webinar sponsored by the ABA SEER Environmental Disclosure Committee featuring as speakers Berkley Adrio, senior associate, Water Programs, Ceres; Marcus Norton, head of Investor Initiatives & Water, Carbon Disclosure Project (CDP); and, Greg Koch, managing director, Global Water Stewardship, Corporate Sustainability Office, the Coca-Cola Company. A brief overview of the information discussed during the webinar is summarized below:

1. Ceres report *Clearing the Waters: A Review of Corporate Water Risk Disclosure in SEC Filing* (June 2012) disclosed key findings:
 - There is significant global freshwater demand gap now and into the future.
 - Focus on water issues by the financial community is growing.

- Disclosure of water risk in SEC filings has increased and more companies are connecting water risks to climate change.
- Data on water use/goals are still lacking as are supply chain risks.

2. CDP reported that investors are waking up to water risks, and that material impacts are already being felt by companies. CDP advised that a three-part questionnaire is used to assess water risks focused on water management and governance; risks and opportunities; and water accounting. In 2012, CDP sent its questionnaire to 650 companies. In 2011 findings included:
 - Water presents a near-term risk but also opportunity.
 - Water management lags behind climate change on the boardroom agenda.
 - Awareness of risk in supply chain is limited.
3. Water is the biggest part of the Coca-Cola Company's (CCC) supply chain and it is under growing stress. Water is the biggest challenge to CCC's 21st-century sustainable communities' goal. Water stress is not only a developing world issue but also one that exists in the United States even today. Examples of water stress include significantly reduced water levels in Lake Mead, Nevada, and Lake Lanier, Georgia. CCC has created a strategic framework focused on managing water stress in four areas, among other goals and initiatives:
 - plant performance
 - watershed protection
 - sustainable communities
 - global awareness and action

Water stress issues in the United States and abroad are growing in number and significance. Recognizing the priority that should be accorded the goal of addressing water needs worldwide, the United Nations has declared that 2013 will be the "International Year of Water Cooperation." The UN hopes the adoption of this special resolution by the general assembly will

serve as a platform to increase people's awareness of water-related problems and promote action on ways to solve them. More information about the International Year of Water Cooperation and the work of UN-Water is available at <http://www.unwater.org/>.

Increased scrutiny on water stress concerns should encourage companies to assess current and future water demands. In doing so, companies will better understand the materiality of water and related risks to their business. Investors and the organizations that represent them want to know more and more about the impact of water risks on company operations and overall financial performance. Whether necessitated by the Securities and Exchange Commission or voluntary, companies can expect more inquiries from investors and shareholders about water stress concerns and more demands for reporting and disclosure.

E. Lynn Grayson is a partner at Jenner & Block in Chicago and cochair of the firm's Environmental and Workplace Health and Safety Practice Group. She is a member of the Environmental Disclosure Committee and moderated the ABA's September 12 webinar on water risks.



HOW INCORPORATION OF IFRS INTO US FINANCIAL REPORTING STANDARDS MAY AFFECT THE REPORTING OF ENVIRONMENTAL LIABILITIES

Brian Henthorn and Lisa Walsh

Summary

In 2000, the United States Securities and Exchange Commission (SEC) began exploring possible convergence of domestic and international accounting standards (International Financial Reporting Standards, or IFRS). Its goal was to create a single set of high-quality global accounting standards. In July 2012, after years of study, the SEC issued a final staff report which discussed some of the implications of incorporating IFRS into the U.S. financial reporting system; however, the staff report did not provide SEC endorsement of an incorporation plan, or a timetable for if and when such an endorsement or decision would be reached.

Much has been written about the history and current status of these incorporation efforts, as well as what the future may hold; however, these articles have not focused explicitly on the effect of IFRS incorporation, if and when it occurs, on the financial reporting of *environmental liabilities*. This article provides a very brief overview of the status of IFRS incorporation efforts, and then focuses on how an SEC decision to endorse or reject incorporation could affect the reporting of environmental liabilities. This article also examines independent efforts to update the U.S. and international accounting standards governing environmental liabilities, and implications for U.S. companies.

Our findings suggest that no significant changes in the requirements governing reporting of environmental liabilities will occur in the United States for at least several years, whether IFRS incorporation is endorsed or not, due to the delays in incorporation and completion of independent projects to update domestic standards and IFRS. Ultimately, however, we believe the SEC will either reject or endorse incorporation with the following potential consequences:

- **If the SEC ultimately rejects incorporation**—the reporting of environmental liabilities in the US would remain unchanged in the short term; however, domestic efforts to improve disclosure of environmental liabilities in U.S. financial statements may affect how these liabilities are disclosed in the long term.
- **If the SEC decides to endorse incorporation**—IFRS will likely become the governing standard for the reporting of environmental liabilities in the United States. Incorporation could result in significant changes to how companies report their environmental liabilities. The SEC has indicated that achieving incorporation may take several years, particularly in areas such as reporting environmental liabilities where there are substantive differences between U.S. and international reporting standards. Additionally, an independent project being undertaken in the United Kingdom to update the IFRS on environmental liabilities should also be monitored, as any changes to the IFRS could affect US companies should incorporation occur.

A Brief History of IFRS Incorporation Efforts

For the last 12 years, the SEC has been exploring possible convergence of domestic and international accounting standards in order to create a single set of high-quality global accounting standards. *See* SEC, February 24, 2010, Commission Statement in Support of Convergence and Global Accounting Standards, p. 4 (SEC 2010 Statement). Efforts began in earnest in 2002 as the domestic (Financial Accounting Standards Board or FASB) and international (International Accounting Standards Board or IASB) accounting boards signed a memorandum of understanding (MoU) to collaborate on the development of common reporting standards. *See* SEC, July 13, 2012, Work Plan for the Consideration of Incorporating IFRS into the Financial Reporting System for U.S. Issuers, Final Staff Report, p. 10 (SEC 2012 Report).

While the two accounting boards continued their efforts to develop common standards in specific areas

through the MoU and other joint projects, in November 2008 the SEC issued a proposed roadmap to the broader incorporation of international financial reporting standards (IFRS) into U.S. reporting standards (Roadmap). Specifically, this Roadmap sought to examine the implications of replacing or merging the domestic financial reporting standards (Generally Accepted Accounting Principles, or GAAP) with IFRS. The Roadmap also provided support for IFRS, stating that “. . . the IFRS has the potential to best provide the common platform on which companies can report and investors can compare financial information.” *See* SEC, Nov. 14, 2008, Roadmap for the Potential Use of Financial Statements Prepared in Accordance with IFRS by U.S. Issuers, pp. 9-11 (SEC 2008 Roadmap).

Momentum toward incorporation of IFRS into US reporting standards began to build in 2010 when the SEC issued a work plan to examine issues raised by commenters to the 2008 Roadmap (Work Plan). The Work Plan also was designed to identify IFRS incorporation issues that would be researched by the SEC, and pave the way for the SEC to decide whether, when, and how to incorporate IFRS. This decision was anticipated in 2011. If the SEC decided in 2011 to transition U.S. GAAP toward IFRS, the first year under a new accounting system was projected to be 2015 or 2016, allowing for a four to five year transition period for U.S. companies to adjust to the new standards. *See* SEC 2010 Statement, p. 2. *See Also* SEC, February 2010, Work Plan for the Consideration of Incorporating IFRS into the Financial Reporting System for U.S. Issuers, pp. 1-3 (SEC 2010 Work Plan).

However, the SEC did not make its decision in 2011. Rather, in July 2012 the SEC staff issued a final report on the issues identified in the 2010 Work Plan; this report further summarized the staff’s findings on the implications of incorporating IFRS in the United States, but did not express any policy recommendation by the SEC staff as to whether IFRS should be incorporated into U.S. financial reporting requirements. *See* SEC 2012 Report, Introductory Note. Just as importantly, the final report did not specify next steps toward a

decision, and did not indicate when such a decision could be reached.

Whereas in 2011 it appeared that the incorporation of IFRS into U.S. financial reporting was forthcoming, the lack of a SEC endorsement as of November 2012 raises questions about if and when IFRS will come to the United States. This article examines the implications for U.S. companies depending on the SEC's decision on incorporation, specifically with regard to the financial reporting of environmental liabilities.

If the SEC Endorses Incorporation of IFRS

Although the SEC has not yet endorsed a specific course of action regarding incorporation, if the SEC ultimately endorses the incorporation of IFRS, this will have varying implications for U.S. companies. While the exact method of incorporation is still uncertain at this time (endorsement, convergence, and "condorsement" are all approaches the SEC has examined), the end result is that U.S. companies will need to be prepared to adopt international accounting standards for their financial reporting. *See* SEC, May 26, 2011, Exploring a Possible Method of Incorporation, pp. 5-7. Condorsement is a hybrid approach that shares characteristics of both the endorsement approach (incorporating individual IFRSs into domestic standards directly) and the convergence approach (maintaining domestic standards but converging those standards to more closely align with IFRS). The condorsement approach would allow the United States to remain the standard setter for domestic standards, and also provide a transition period for individual standards to be converged, such that eventually compliance in GAAP would also represent compliance with IFRS.

For many areas where U.S. GAAP and IFRS are already similar, or where joint projects under the MoU have converged the standards, this transition will be relatively straightforward. Contingent and environmental liabilities, however, have fundamental differences between U.S. GAAP and IFRS. *See* SEC 2012 Report, pp. 14-15.

Key Differences Between IFRS and US GAAP Governing the Reporting of Environmental Liabilities

The first major difference between IFRS and U.S. GAAP treatment of environmental liabilities for financial reporting purposes is the threshold under which a liability is recognized. Both standards (FASB Accounting Standards Codification–Topic 450 (Contingencies), or ASC 450 and International Accounting Standard 37–Provisions, Contingent Liabilities and Contingent Assets, or IAS 37) use the term "probable"; however each standard defines that term differently. Under U.S. GAAP, probable is defined as when an "event or events are likely to occur." *See* ASC 450-20-20. Interpretations of what "likely" means may vary; however the American Institute of Certified Public Accountants (AICPA) states that it is "typically interpreted to mean about 80%." *See* AICPA Website, IFRS for SMEs–U.S. GAAP Comparison Wiki, <http://wiki.ifrs.com/Provisions-and-Contingencies> (AICPA Website). IFRS, on the other hand, defines probable as "more likely than not," which would mean any likelihood above 50 percent. *See* IAS 37, p. A1016. *See Also* SEC, Nov. 16, 2011, A Comparison of U.S. GAAP and IFRS, p. 30.

Another major difference between IFRS and US GAAP is in the measurement of a liability within a range. U.S. GAAP requires the measurement to be an entity's best estimate, or if no amount within a range is better than any other estimate, the minimum of that range. *See* ASC 450-20-30-1. IFRS requires that the estimate should be "the amount that an entity would rationally pay to settle or transfer the obligation ..." Uncertainties in the estimate should be measured by using an expected value or mid-point of the range, depending on the specific circumstances. *See* IAS 37, p. A1018.

Finally, one other major difference is in the measurement of a liability with regard to timing. U.S. GAAP requires that the measurement should be the

cost of performing the remediation “when it is expected to be performed” (i.e., undiscounted). *See* AICPA Website. IFRS requires that liabilities be discounted to calculate a net present value. *See* IAS 37, p. A1020.

Impact of Key Differences

The above—and other differences—can result in large changes in environmental accruals if a company must transition from U.S. GAAP to IFRS. Specifically, with regard to recognition of a loss, U.S. GAAP uses a higher threshold (approx. 80 percent) than IFRS (greater than 50 percent); the impact is that liabilities will be recognized earlier under IFRS than under U.S. GAAP. *See* SEC 2012 Report, p. 15.

Additionally, with regard to the measurement of a loss, the amount recognized under IFRS is likely to be higher than that under U.S. GAAP, especially when uncertainty is involved. This is because U.S. GAAP allows one to accrue the minimum of a range if no estimate within the range is better than another; IFRS requires that “all possible” outcomes be considered in calculating an expected value or mid-point of the range. *See* IAS 37, p. A1018. Thus, by definition, estimates prepared under IFRS would consider high-cost, low-probability outcomes as well as the minimum cost outcome. Moreover, whereas U.S. GAAP requires the development of one estimate (the minimum), under IFRS in order to calculate an expected value or mid-point, a range of estimates must be prepared.

In an interview with *Accounting Today* in September 2012, FASB Chair Leslie Seidman discussed some of the hurdles that had arisen which made universal adoption of IFRS problematic and unlikely, one of which was the differences in the accounting of environmental liabilities:

So, it means there has to be some sort of a transition plan for those cases where we have gaps in IFRS, if you will, and then the other cases where there might be concerns about the consistency of application of IFRS in a particular area, or cases where we think that there are problems with applying an existing

IFRS standard in the US environment; such as, for example, the accounting for contingencies, where we've heard widespread concern about using an expected value type approach in the US environment.

See Accounting Today TV, Sept. 6, 2012, Interview with FASB Chair Leslie Seidman on Convergence with IFRS.

Increases in the measurement of environmental liabilities under IFRS may be offset to some extent by the requirement to discount the liabilities to account for the time value of money.

Whether or not the reduction from calculating a present value offsets the increase from using the expected value methodology depends on the specific circumstances surrounding the uncertainty of the response action and the associated cash flows of the liability being measured.

Other Potential Changes to the IFRS Governing the Reporting of Environmental Liabilities

In addition to the global IFRS incorporation efforts, the IASB has been in the process of updating the IFRS governing environmental liabilities (IAS 37: Provisions, Contingent Liabilities, and Contingent Assets) since 2005. Should this update be completed prior to incorporation of IFRS in the United States, any changes to IFRS proposed in the update would become applicable to U.S. companies after incorporation is completed.

Updating IAS 37 began in June 2005, when the IASB issued its first exposure draft. Two of the primary goals of the IAS 37 update were to address inconsistencies with other IFRSs, and to improve the measurement of liabilities. *See* IASB, January 2010, Exposure Draft Snapshot: IAS 37 Replacement, p. 2. With regard to the inconsistencies with other standards, IASB proposed to remove the probable (more likely than not) threshold from IAS 37, as it was not used in other standards, and it was deemed to be unnecessary if an expected value approach to measurement was used.

With regard to the measurement of liabilities, the board proposed to specify that an expected value or expected cash flow approach should be always used to measure an environmental liability. *See* IASB, June 2005, Exposure Draft of Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits, pp. 15-16. *See also* IASB, September 2010, Staff Paper: Liabilities–IFRS to replace IAS 37, p. 10 (2010 IASB Staff Paper).

Commenters to the first exposure draft issued in 2005 voiced concerns about the changes to the measurement of liabilities, and as a result, the draft was revised in January 2010 with additional guidance specifying precisely what entities should measure, and how they should achieve that aim. Specifically, the revisions noted that the expected value calculation should be based on contractor prices, and include a risk premium. *See* IASB, January 2010, Exposure Draft: Measurement of Liabilities in IAS 37, p. 5. *See Also* 2010 IASB Staff Paper, p. 4.

Further comments were received in 2010, some of which included opposition to some of the proposed changes, specifically with regard to the use of expected value, measurement of contractor prices, and judgment about whether a liability exists. As a result, in November 2010 IASB proposed to reverse its changes on the recognition threshold, and keep the probable (more likely than not) threshold. *See* IASB Staff Paper, pp. 10–14. *See also* IASB, November 2010, Staff Paper: Liabilities–IFRS to Replace IAS 37, Recognition Criteria–Threshold for “Liability Exists” Criterion, p. 6. IASB did not address commenters’ concerns regarding expected value or the use of contractor prices.

Before any revisions could be made to IASB’s exposure draft, the update project was paused and staff was transferred to work on higher priority projects. *See* IASB and FASB, Nov. 29, 2010, Progress Report on Commitment to Convergence of Accounting Standards and a Single Set of High Quality Global Accounting Standards, p. 2. The IFRS website for the project indicates that it has been on hold since

January 2011 pending ongoing deliberations about the IASB future work plan. *See* IFRS Website, Jan. 26, 2011, Liabilities–Amendments to IAS 37 (Paused), <http://www.ifrs.org/Current-Projects/IASB-Projects/Liabilities/Pages/Liabilities.aspx>.

Timing of IFRS Incorporation for U.S. Companies

In its February 2010 Work Plan, the SEC estimated that a transition to incorporate IFRS in the US would take approximately four to five years. *See* SEC 2010 Work Plan, pp. 1–3. As of November 2012, no decision had been reached by the SEC. It appears unlikely that any decision will be reached until 2013 at the earliest. Furthermore, the four to five year transition period may be an underestimate for certain standards. The July 2012 final report by SEC staff noted that for standards with fundamental differences between U.S. GAAP and IFRS (such as environmental liabilities) it may be difficult to resolve those differences even within five to seven years. *See* SEC 2012 Report, p. 14. This time frame does not account for the independent effort to update IAS 37. While this effort is currently paused, should efforts resume this may also prolong the time period necessary to converge the standards governing the reporting of environmental liabilities.

If the SEC decides to endorse incorporation of IFRS in 2013, the effects of incorporation are unlikely to be felt by U.S. companies for several years. A prudent long-term strategy for companies is to closely monitor any decisions from the SEC that may affect the timing of incorporation, as well as monitor any potential changes to IAS 37.

If the SEC Rejects Incorporation of IFRS

Companies which currently have or may have in the future an international presence should continue to monitor developments in IFRS. If the SEC decides to reject incorporation of IFRS into U.S. GAAP standards, U.S. companies will not have to consider the implications of IFRS on their domestic reporting of environmental liabilities. However, for companies that have international operations, there may still be requirements to file separate financial statements

domestically under U.S. GAAP, and internationally under IFRS.

Changes to the U.S. GAAP Standard Governing the Reporting of Environmental Liabilities

Even for those companies which solely operate in the US, a decision to reject incorporation of IFRS does not mean that no changes will be made to domestic accounting standards. Separate from the global IFRS incorporation efforts, since 2008 the FASB has been in the process of updating the U.S. GAAP standard governing reporting of environmental liabilities. As of 2008, this was the Statement of Financial Accounting Standards No. 5 (FAS 5): Accounting for Contingencies; however, FAS 5 was subsequently codified in 2009 as FASB Accounting Standards (ASC) Topic 450 (Contingencies).

In 2008, FASB issued an exposure draft on the Disclosure of Certain Loss Contingencies, intended to amend the existing FAS 5. The amendment would expand the disclosures of certain loss contingencies including environmental liabilities. Specific changes anticipated in the exposure draft included requiring more quantitative and qualitative information about disclosures, tracking changes in disclosures over time, and requiring disclosures for liabilities whose likelihood was believed to be remote if they would be expected to result in a material loss. *See* FASB, June 5, 2008, Exposure Draft–Disclosure of Certain Loss Contingencies, pp. v-vi.

Based on opposition expressed in comments to the exposure draft, largely from the legal profession, the exposure draft was withdrawn. In July 2010, a new exposure draft was issued, with some changes from the 2008 version to address the commenters' concerns. One of the objectives of the exposure draft was to make the disclosures under U.S. GAAP similar to those required by IAS 37 under IFRS. *See* FASB, August 2010, FASB In Focus–Proposed Accounting Standards Update: Disclosures of Certain Loss Contingencies, p. 1. *See Also* FASB, July 20, 2010, Exposure Draft–Contingencies (Topic 450), p. 3 (2010 FASB Exposure Draft).

If the exposure draft had been finalized as re-issued, the guidance would have become effective in December 2010. *See* 2010 FASB Exposure Draft, p. 46. However, commenters continued to express opposition to the revised draft. In particular, commenter opposition focused on the possibility that enhanced disclosures could be prejudicial to the reporting entity. Furthermore, some commenters believed that disclosures could be improved by enforcing compliance with the existing standards, rather than changing the existing standards. *See* FASB, July 9, 2012, Board Meeting Handout: Disclosure of Certain Loss Contingencies, p. 1 (2012 FASB Handout). As a result, the exposure draft was not finalized in December 2010.

In July 2012, a FASB board meeting was held to discuss the project objectives and determine next steps. The board noted that feedback received on both the 2008 and 2010 exposure drafts was overwhelmingly negative. *See* 2012 FASB Handout, p. 1. As a result, FASB voted to discontinue the project. *See* FASB, July 12, 2012, Minutes of the July 9, 2012 Board Meeting: Disclosure of Certain Loss Contingencies, p. 2. According to FASB Chair Leslie Seidman:

Based on feedback received from a wide range of constituents on two exposure drafts over a period of four years, the board concluded that existing loss contingency disclosure requirements are adequate. As a result of the increased scrutiny of loss contingency disclosures in recent years, the board concluded that improvements to financial reporting are more likely to be achieved through robust compliance than through additional standard setting.

Changes to the U.S. GAAP Standard on Disclosures

While the project to update disclosure requirements for environmental liabilities was terminated, another separate project continued whose purpose is to update disclosures across financial statements as a whole (not solely limited to environmental liabilities). Specifically, in July 2012, FASB issued a discussion paper on

improving the effectiveness of disclosures in notes to financial statements. This discussion paper included a number of proposals to improve disclosures, many of which were previously discussed in the rejected exposure draft for environmental liabilities. *See* FASB, July 12, 2012, Discussion Paper–Disclosure Framework, p. 1 (2012 FASB Discussion Paper).

For example, the discussion paper noted that FASB should consider requiring companies to track changes in disclosures over time, and detail the reason for these changes. The discussion paper also noted that in determining whether to disclose a liability, a loose approximation of the probability-weighted value should be used to assess materiality. Furthermore, liabilities whose likelihood is believed to be remote but is of high magnitude would require disclosure. *See* 2012 FASB Discussion Paper, pp. 23, 48.

Due to the early stage of this general disclosure project (comments on the discussion paper are due in mid-November 2012), it is too soon to tell whether the proposed revisions to disclosures will be retained or modified in future drafts, and if and when those revisions would go into effect. At a minimum, it is unlikely that there will be any changes to disclosure requirements for at least a year. Given the large number of comments expressed on the proposed (and ultimately rejected) update to FAS 5 and ASC 450, which contained many of the same changes as the disclosure discussion paper, it should not be surprising if there are substantive concerns expressed to the broader discussion paper on disclosures as well. As a result, it could take several years to finalize an update to disclosure requirements and satisfy commenters' concerns.

Conclusion

Unlike last year, when an SEC decision to endorse IFRS incorporation appeared imminent, and when updates to domestic and international accounting of environmental liabilities were proceeding along separate but parallel tracks, it now appears unlikely that there will be any changes required as to how U.S. companies report environmental liabilities within the next several years. While updates to domestic and international standards on environmental liabilities have

been paused or ceased, this does not preclude the restarting of these projects in the future, or in the case of domestic standards, the issuance of revised disclosure standards for financial statements in general. Furthermore, unlike the IFRS incorporation efforts where it is expected that companies will have multiple years to transition to IFRS, updates to domestic standards could be implemented relatively quickly following standard finalization.

Many reasons remain for companies to continue to monitor developments in the United States and abroad and to evaluate the implications of incorporating certain individual IFRSs into U.S. reporting, including the reporting of environmental liabilities. Specifically, as companies grow globally, they may be subject to IFRS. Also, companies with non-U.S. subsidiaries, stakeholders and vendors must remain aware of changes to domestic and international standards. Understanding the evolution of these standards will help companies minimize the impact of reporting under different accounting standards across the globe. Finally, it is critical to involve securities counsel in the review and proper implementation of these evolving standards.

While more uncertain than it was a year ago, some incorporation of IFRS into U.S. financial reporting still appears likely. Companies that proactively consider and analyze the impacts of incorporation (specifically for areas with major differences in the standards, such as reporting environmental liabilities) will be better positioned to adopt new standards with minimum disruption should incorporation occur.

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The opinions express are those of the authors and do not necessarily reflect the views of the firm or its clients. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

UNCOVERING THE MYSTERY OF MATERIALITY IN TODAY'S MARKET

Jerome Lavigne-Delville, J.D., and
Jean Rogers, Ph.D.

On October 4, 2012, the Sustainability Accounting Standards Board (SASB) was officially launched in San Francisco, with the goal of developing and publicly distributing comprehensive, industry-specific sustainability accounting standards for companies, investors, and the public. To understand the significance of this mission requires a closer look at the evolution of corporate disclosure in the United States, the challenges that have necessitated this new set of standards, and the multi-stakeholder benefits of mandating sustainability disclosure. A recent white paper entitled *On Materiality and Sustainability: The Value of Disclosure in the Capital Markets*, released by the Initiative for Responsible Investment at Harvard University, offers a clear and compelling argument for incorporating material, non-financial issues in corporate reporting, as well as methods to identify and monitor these issues.

The paper further elaborates on a 2010 white paper entitled *From Transparency to Performance: Industry-Based Sustainability Reporting on Key Issues*, also published by the Initiative for Responsible Investments, which presented a framework for how industry-based Key Performance Indicators (KPIs) could be developed. In proposing a mandated system of KPIs, authors Steve Lydenberg, Jean Rogers, and David Wood sought to create guidance that was relevant to the core operations of a business. Citing the need for standard, mandated KPIs, the authors wrote: "As an increasing number of governments and stock exchanges encourage or require sustainability reporting, corporations and financial markets in the United States run the risk of diminishing their competitiveness in sustainability. This data could be crucial in aligning business practices with those of a sustainable economy and in providing a means for benchmarking the performance of large corporations as they interact with society and the environment."

History of Corporate Disclosure

As a result of the Securities Exchange Act of 1934, Congress created the Securities and Exchange Commission (SEC), a new federal agency charged with market oversight. Congress empowered this agency to both require corporate disclosure for the first time, and oversee that disclosure. The need for both was evident in the wake of the 1929 stock market crash and the Great Depression, which shook public trust and investors' confidence in the financial market. By mandating this disclosure, Congress aimed to assure fair and honest markets, reliable prices, and unencumbered interstate commerce. The exact information required for corporate disclosure, however, was (and has been) left to interpretation, for the most part. The courts and the SEC have "generally defined information sufficiently 'material' to require reporting as information that would be useful to 'reasonable' investors considering a 'total mix' of information in their decision making," according to *Materiality and Sustainability*.

At the time, many, including the SEC, interpreted this mandate to include reporting on corporate financials, and did not consider sustainability data, or ESG (environmental, social, and governance) as part of required reporting. For many years, reports on the financial conditions of publicly traded corporations were indeed sufficient to assure trust in the companies and the financial markets on which their stocks were traded.

In 1973, the SEC created the Financial Accounting Standards Board (FASB), an accounting oversight body to ensure that financial reporting was trustworthy, on the recommendation of the Wheat Committee through its 1972 "Report of the Study on Establishment of Accounting Principles." Francis M. Wheat, an attorney and former commissioner of the Securities and Exchange Commission, chaired the seven-member study group.

By requiring the transparent disclosure of material issues to investors, the U.S. financial accounting system plays a fundamental role in making our markets the most efficient, liquid, and resilient in the world. However, the construct for standardized financial

reporting to investors was developed in a time when a company's ability to create value was constrained largely by the ability to access financial capital.

The Growing Demand for Sustainability Data

Today's market faces new and different challenges from that of 1934, when the SEC was created, or even 1973, when FASB was formed. Since then, companies have been operating in a much more global environment, facing a new set of risks and opportunities, and significant resource constraints beyond access to capital. This is accompanied by a significant rise of intangible value as part of companies' total market value, from 18 percent in 1975 to 80 percent today, highlighting both the limitation of the current accounting system and the emergence of new, less tangible value drivers, including environmental, social, and governance factors.

Building on the foundations laid by the SEC and FASB a new, standardized language is needed to articulate the material, non-financial risks and opportunities facing companies today. These non-financial risks and opportunities that affect corporations' ability to create long-term value are characterized as "sustainability" issues. Sustainability issues vary by industry because they are closely aligned with business models, the way companies compete, their use of resources, and their impact on society.

Some argue there is legal standing to mandate sustainability disclosure. A number of legal scholars have recently pointed out that the SEC has the ability under the current law to require the disclosure of non-financial data—including sustainability or ESG—as it deems necessary.

Materiality and Sustainability adds:

[Legal scholars] have also argued that the SEC has an obligation to require sustainability disclosure if a substantial portion of the investment community considers this information material (a substantial number of institutional investors now assert ESG data is important to their investment process); if

corporations are disclosing only "half-truths" (several thousand corporations worldwide now publish sustainability reports, but in widely differing depths and formats); and if asymmetries in the availability of corporate data exist (a widening gap exists between institutional investors who have access to ESG data and retail investors who do not).

Because current regulatory and legal frameworks are sufficiently broad, and material information is already required to be disclosed by the SEC, there is an opportunity—and a growing necessity—to standardize industry-specific sustainability key performance indicators, which SASB aims to develop. With better clarity on the materiality of ESG issues, and a standardized format for disclosure underpinned by verifiable data, the information becomes decision-useful for investors and the public. A decision-useful format, i.e., one that enables peer-to-peer comparison and benchmarking, is critical to meet the current demand for disclosure from market participants who understand the risks, as well as the opportunities, posed by today's ESG challenges. Relentless attention to the materiality of the issues as well as a standardized form of disclosure will create a de facto mandatory reporting environment in the United States without the need for any additional regulation. As companies begin to report performance on material ESG issues facing their industry, negative attention from market beneficiaries will shift from those *disclosing* material information to those *omitting* material information, further fueling the demand.

Materiality and Sustainability states the broader implications of sustainability disclosure: "Put simply, disclosure of material sustainability data is necessary to assess corporations' ability to disrupt—either positively or negatively—the economic, environmental, and social systems within which they operate under conditions of substantial complexity and uncertainty. The greater the potential for corporate practices to impact these systems, the longer the term of these potential impacts, and the greater the uncertainties involved, the greater the need for disclosure." Since the 1980s, investors, stock exchanges, regulators, and corporations have shown growing

interest in such reporting. Among the indications of this growing demand, as cited by *Materiality and Sustainability*, are:

- the Principles for Responsible development, whose institutional investors as of 2012 numbered over 1000 and represented assets under management of some \$30 trillion
- the listing requirements by various stock exchanges around the world, including those in South Africa, China, Brazil, and India, for disclosure of sustainability data as a component of good governance
- the requirement of regulators, including those in France, Denmark, Sweden, China, Malaysia, and Indonesia, that corporations report on sustainability issues or explain why they do not do so
- the Securities and Exchange Commission's 2001 ruling that asset owners have a fiduciary duty to vote on shareholder resolutions appearing on corporate proxy statements, hundreds of which address environmental, social, and governance issues each year
- a 2009 Robeco and Booz & Co. study estimated socially responsible assets under management as of 2007 at \$5 trillion worldwide and projected growth to \$26.5 trillion, or 15 percent to 20 percent of total assets by 2015

Multi-stakeholder Benefits of Disclosure

The benefits of sustainability data are manifold, though at the core, they are very aligned with the original goals of the SEC and FASB: to ensure public and investors' trust, as well as enable a robust sustainable market. At the macro level, such data can help reduce financial risks and increase investment opportunities, while mitigating distrust and excessive speculation, and "averting, moderating, or shortening national emergencies caused by financial crises or corporate misdeeds," according to *Materiality and Sustainability*.

At the micro level, each stakeholder stands to benefit from the integration of sustainability data in corporate reporting—from investors, corporations, and

governments, to our capital markets and the general public. While the systematic disclosure of material sustainability KPIs will come at some cost to corporations, it will lead to a substantial return on investment. As outlined in the white paper, these benefits include increased competitiveness of U.S. financial markets and corporations; reduced overall costs and liabilities for corporations; increased provision of products and services with broad societal benefits; and reduced governmental oversight and regulatory burdens, among many others.

In addition, it is SASB's belief that the existence of comprehensive, industry-specific sustainability accounting standards will provide investors and companies with decision-useful, comparable information on material issues with the potential to affect short- and long-term value creation.

The Role of SASB

The Sustainability Accounting Standards Board was founded to fill a current void in corporate reporting by quantifying the value of corporate non-financial information. SASB will develop and publicly distribute comprehensive, industry-specific sustainability accounting standards for the benefit of companies, investors, and the public.

As its first initiative, SASB is producing a Materiality Map that weights the priority of sustainability issues by industry across 10 sectors, which is useful for asset allocation strategies and understanding exposure to certain kinds of environmental, social, and governance risk. SASB will also identify issues deemed most material in each of 89 industries through an evidence-based approach, and will develop corresponding key performance indicators suitable for disclosure in the Form 10-K, thereby facilitating comparable corporate reporting. Bloomberg LP, an early supporter of SASB, will also collaborate in developing the evidence-based Materiality Map by enabling robust searching of tens of thousands of source documents to substantiate the materiality of ESG issues and create unique industry profiles.

For the various reasons stated in this article, and beyond, there is a growing need for sustainability data

disclosure to insure the public and investors' trust—both of which are the lifeblood for a healthy market. The growing demand for this data has posed several challenges, the most problematic of which is a resulting myriad of data reporting styles, and the proliferation of immaterial information. The increased interest in disclosure beyond financial data has led to numerous methods of sustainability reporting that vary greatly between corporations and industries in the United States. While the need for such disclosure is crucial in today's market, inconsistency in reporting has raised more challenges than solutions. Much of the disparity is due to different interpretations of what is sufficiently "material" to report, as required by the SEC.

SASB aims to simplify and streamline the process by establishing an understanding of material sustainability issues facing industries and creating sustainability accounting standards suitable for disclosure in standard filings. The creation of the SEC and FASB has been instrumental to attaining the level of financial reporting necessary to maintain well-functioning capital markets. SASB will continue that evolution by standardizing disclosure of sustainability information, which is increasingly material but not currently available in a decision-useful format. A complete view of risks and opportunities will reestablish the trust that fuels corporations and the financial markets, and our capital markets will be better able to meet the needs of investors and society.

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Jean Rogers is executive director and founder of SASB. She is a former Loeb Fellow at Harvard University who has authored multiple publications and won several awards. Dr. Rogers holds a Ph.D. in environmental engineering from the Illinois Institute of Technology, an M.E. in environmental engineering and a B.E. in civil engineering, both from Manhattan College.

CALL FOR NOMINATIONS

Environment, Energy, and Resources Dedication to Diversity and Justice Award

This award will recognize people, entities, or organizations that have made significant accomplishments or demonstrated recognized leadership in the areas of environmental justice and/or a commitment to gender, racial, and ethnic diversity in the environment, energy, and natural resources legal area. Accomplishments in promoting access to environment/energy/resources rule of law and to justice can also be recognized via this award.

2013 ABA Award for Distinguished Achievement in Environmental Law and Policy

This award recognizes individuals or organizations who have distinguished themselves in environmental law and policy, contributing significant leadership in improving the substance, process or understanding of environmental protection and sustainable development.

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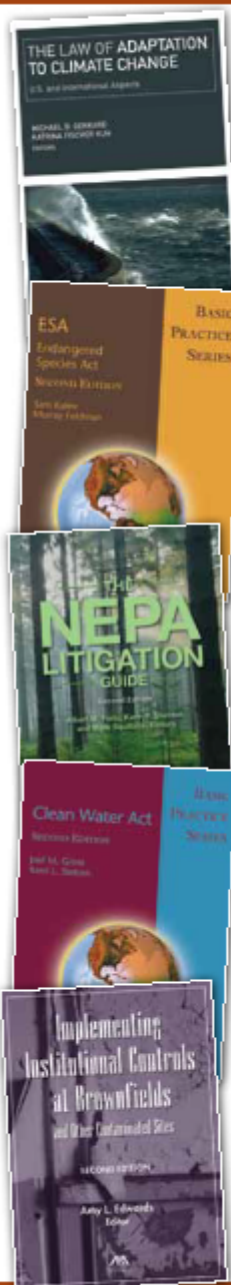
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