

## SEC ORDER PROVIDES INSIGHT ON PRACTICES AND PROCEDURES FOR SETTING ENVIRONMENTAL RESERVES

On November 29, 2006, the Securities and Exchange Commission (the “SEC”) issued an administrative cease-and-desist settlement order that provides insight into possible increased scrutiny by the SEC of procedures for setting and reporting environmental reserves, as well as best practices for compliance with Generally Accepted Accounting Principles (“GAAP”).<sup>1</sup> The order focuses upon an alleged lack of documentation for reductions in environmental reserves made by the Director of Environmental Remediation (“Director”) of a Fortune 500 chemical company (the “Company”), as well as allegedly inadequate internal accounting controls. Included in the SEC’s order is a list of procedures to help ensure future compliance with GAAP and SEC reporting requirements. Such procedures and other considerations discussed below are potentially instructive to public companies engaged in reviewing their practices for setting environmental reserves.<sup>2</sup>

### I. Factual Background

In its administrative order, the SEC alleged that there was no documented reasonable basis for certain environmental reserve estimate reductions made by the Company’s former Director between the years 1999 and 2001. For the period in question, the Director was reportedly responsible for overseeing the determination of the Company’s environmental liability reserves. He supervised a group of six engineers who calculated initial liability estimates for cleanup sites in consultation with an independent outside consultant. The consultant entered such estimates into a computer program to generate a probability range for the total future cleanup costs for each site. This result was then forwarded to the Director for his review. Company procedures would have permitted the Director to correct mistakes or otherwise adjust the estimates, provided that he had a reasonable basis to do so. The SEC alleged, however, that the Director made multiple reductions (many of them across-the-board by a similar percentage) in 1999, 2000, and 2001 with no reasonable basis or supporting documentation. These alterations resulted in substantial reductions in environmental reserves as well as significant increases in net income shown on the Company’s public balance sheets included in annual reports and financial statements to the SEC and individual investors.

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<sup>1</sup> GAAP are standards set by the Financial Accounting Standards Board (“FASB”). For instance, according to GAAP, items listed in financial accounting statements must be reliable, and companies must accrue an environmental reserve for estimated costs of future remediation. A similar provision is included in the Securities Exchange Act of 1934 (the “Exchange Act”) § 13(a), which requires public companies to file “true and correct” annual and quarterly reports.

<sup>2</sup> The SEC order on this matter, *In re Ashland Inc. and William C. Olasin*, File No. 3-12487, is available at <http://www.sec.gov/litigation/admin/2006/34-54830.pdf>. Additional information is available in the SEC press release regarding the order, available at <http://www.sec.gov/news/digest/2006/dig112906.txt>.

Notably, the SEC settlement order indicates that the Director's alleged practices came to light through complaints from one of the Company's engineers who had been involved in calculating the Company's initial liability estimates. Following an internal audit conducted by the Company in response to these complaints, the Director learned the identity of the engineer. Reportedly, the Director then made remarks that led the engineer to file a complaint with the U.S. Department of Labor under the whistle-blower protection provisions of the Sarbanes-Oxley Act of 2002.

## **II. The SEC Alleges that Revisions to Environmental Reserves Violated GAAP and SEC Statutes and Regulations**

The SEC alleged that, while the Company had a detailed system for estimating its environmental costs, the Company's process for setting its environmental reserves did not include adequate guidelines or requirements for documentation or review of adjustments to such cost estimates. The SEC also noted that the Company's internal controls were designed by the person they were meant to regulate, the Director himself. The SEC alleged that the Director was therefore able to reduce the environmental cleanup cost estimates without a reasonable basis or documentation.

Accordingly, the SEC alleged that the Company had violated reporting, recordkeeping, and internal control requirements under the following statutes and rules:

- Exchange Act § 13(a) and SEC Rules 13a-1 and 13a-13, concerning the obligation to file true and correct annual and quarterly reports to the SEC;
- SEC Rule 12b-20, concerning the obligation to include any information necessary to ensure that required statements are not materially misleading;
- Exchange Act § 13(b)(2)(A), concerning the obligation to make and keep books, records, and accounts that accurately and fairly reflect the transactions and dispositions of assets;<sup>3</sup> and
- Exchange Act § 13(b)(2)(B), concerning the obligation to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that financial statements are made in conformity with GAAP.

## **III. Recommendations for "Best Practices" in Setting Environmental Reserves**

The SEC's decision to take action in this case highlights the importance of implementing a consistent, documented methodology for environmental accounting that meets the SEC's interpretation of GAAP and the SEC's reporting, record-keeping, and internal control requirements. Moreover, the Company's settlement agreement with the SEC (entered into

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<sup>3</sup> With reference to the Director himself, the SEC also alleged a violation of SEC Rule 13b2-1 concerning the prohibition against direct or indirect falsification of any book, record, or account subject to Exchange Act § 13(b)(2)(A).

without any admission of wrongdoing or imposition of penalties) includes specific practice changes that provide guidance for other companies to consider when reviewing internal controls and procedures for setting environmental reserves. These include, but are not limited to, the following:

- Document reasons for all adjustments to reserve estimates to create a clear audit trail;
- Retain records of reserve estimates for at least seven years;
- Require that the manager of the Environmental Remediation Group (or any other person who makes adjustments to reserve estimates) consult with the engineers responsible for each site before making adjustments to estimates;
- Distribute internal questionnaires to members of the Environmental Remediation Group and the Accounting Department (or any other departments that create cost estimates for the company) regarding whether there has been a failure to follow reserve-setting procedures or any misstatement in books and records concerning environmental remediation reserves;
- Compare each cleanup site's reserve estimate to the site's annual budget and historical expenditures;
- Analyze annual best practice reviews with the assistance of an outside auditor;
- Engage an outside accounting firm to review policies and internal controls for reserve estimates; and
- Implement a system for solicitation and investigation of internal complaints from employees, including measures for prevention of retaliation against complainants.

In addition to the above procedures for setting environmental reserves mentioned in the SEC's settlement order, the following are offered as suggestions for companies to consider in developing their processes for environmental disclosures:<sup>4</sup>

- Adopt a formal methodology to ensure that environmental disclosures are considered on a quarterly and annual basis, especially in the mining, manufacturing, chemical, building, petroleum, pulp and paper, and insurance fields;
- Ensure that the elements of the environmental disclosure methodology are complied with by designating a senior officer to take responsibility for the process and, if appropriate, a board committee to oversee the process;
- Keep a record of efforts taken to develop data, as well as reasons for particular disclosure determinations;

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<sup>4</sup> See E. Donald Elliott, et al., A Practical Guide to Writing Environmental Disclosures, 25 ENVTL. LAW REP. 10237, 10241-42 (1995).

- Monitor new developments within the company and periodically reassess whether additional disclosures are required;
- Consider retaining outside environmental consultants to assist in data-gathering, evaluation, and disclosure;
- Advise environmental and securities counsel to consult with tax counsel regarding tax treatment of environmental liabilities;
- Provide consistent information in filings with the SEC and in responses to Environmental Protection Agency (“EPA”) inquiries, because the two agencies share data;
- Review the regulatory landscape and estimate the cost of future compliance;
- Review competitors’ difficulties with the disclosure process, and adjust internal methods to avoid similar setbacks; and
- Consider whether the company is required to report any environmental loss contingencies (Financial Accounting Standard (“FAS”) No. 5) and/or conditional asset retirement obligations (FASB Interpretation No. 47 (“FIN 47”) of FAS No. 143).

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