Environmental Compliance and Sarbanes-Oxley

Sarbanes-Oxley

Environmental Compliance

NCASI Western Regional Meeting
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Outline

- Intro and pre-Sarbanes-Oxley requirements
- Application of Sarbanes-Oxley to Environmental Disclosure
- The EMS as a tool for Sarbanes-Oxley compliance
- Seven Elements of an Effective Compliance Program
- The role of a technology solution in satisfying Sarbanes-Oxley
Introduction

- Sarbanes-Oxley (Sarbox) is intended to restore investor confidence by
  - increasing the accuracy and reliability of public disclosures (largely public companies’ financial statements)
  - improving corporate governance through various means, including threat of CEO/CFO income disgorgement

- Sarbox written broadly, and can encompass environmental issues
  - Environmental liabilities are financial liabilities, too

- Sarbox isn’t the first instance of required environmental disclosure in corporate reporting to SEC
Pre-existing SEC Disclosure Requirements

- SEC Regulation S-K
  - In Management Discussion and Analysis (MD&A), Rule 303, disclose known events or uncertainties known to management reasonably likely to have an effect on the financial condition or operating results (SEC alleges vast lip service here)
  - Must also disclose material CapEx for environmental control facilities

- FAS5: Contingent liabilities
Pre-existing SEC Disclosure Requirements (cont.)

- Example applications in the pulp and paper industry
  - Environmental Remediation (cleanup and closure) at landfills (CERCLA)
  - MACT requirements (e.g., Cluster Rule, Combustion)
  - CapEx associated with TMDL allocations
MANAGEMENT'S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS

Net sales in 2001 were $23,852 million, a decrease of $1,277 million, or 5 percent compared with 2000. Net sales in 2000 were $25,129 million, an increase of $1,288 million, or 5 percent compared with 1999. The change in net sales in 2001 and 2000 is attributable to the following:

<table>
<thead>
<tr>
<th>Component</th>
<th>2001 vs. 2000</th>
<th>2000 vs. 1999</th>
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<tbody>
<tr>
<td>Acquisitions</td>
<td>1%</td>
<td>9%</td>
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<tr>
<td>Directories</td>
<td>(4)</td>
<td>(5)</td>
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<tr>
<td>Foreign Exchange</td>
<td>(1)</td>
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<tr>
<td>Price/Volume</td>
<td>(5)</td>
<td>(5)</td>
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<td>(9)%</td>
<td>(5)%</td>
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Cost of goods sold of $20,429, $18,090, and $16,485 million in 2001, 2000, and 1999, respectively, included margin, repositioning and other charges of $2,456, $2,886, and $967 million in 2001, 2000, and 1999, respectively. See Note 10 of to Financial Statements for further discussion of the margin, repositioning and other charges, including these charges, cost of goods sold was $17,971, $15,204, and $14,518 million in 2001, 2000, and 1999, respectively. The increase in cost of goods sold as a percentage of sales in 2001 compared with 2000 principally reflected significantly lower sales in our Specialty Materials segment and lower sales of high-margin aftermarket products and services in our Aerospace segment. This increase was partially offset by lower costs due to headcount reductions and increased sales of high-margin aftermarket products and services in our Aerospace segment partially offset by higher raw material costs primarily in our Specialty Materials segment.

Selling, general and administrative expenses were $3,054, $3,152, and $3,215 million in 2001, 2000, and 1999, respectively, selling, general and administrative expenses included margin, repositioning and other charges of $151 and $200 million in 2001 and 2000, respectively. See Note 10 of to Financial Statements for further discussion of the margin, repositioning and other charges, including these charges, selling, general and administrative expenses were 12.9, 12.5, and 12.3 percent in 2001, 2000, and 1999, respectively. The decrease in cost of goods sold as a percentage of sales in 2001 compared with 2000 principally reflected the impact of headcount reductions and a decline in discretionary spending for professional services, travel and overtime. The increase in selling, general and administrative expenses as a percent of sales in 2000 compared with 1999 principally reflected our acquisition of Pitney Bowes, which had a higher level of selling, general and administrative expenses as a percent of sales.

Retirement benefit (pension and other post-retirement) plans contributed net reductions of $165, $262, and $611 million in 2001, 2000, and 1999, respectively, principally due to the funding status of our pension plans (discussed in Note 23 of to Financial Statements and footnotes to financial statements). Future effects on operating results will principally depend on pension plan investment performance and other economic conditions.

GAIN on sale of non-strategic businesses of $112 million in 2002 represented the pre-tax gain on the government-managed divestiture of the TCAO product line of Honeywell Inc. (the former Honeywell) in connection with the merger of AlliedSignal Inc. and the former Honeywell in December 1999. GAIN on sale of non-strategic businesses of $108 million in 1999 represented the pre-tax gain on the sale of our Laminated System businesses. See Note 5 of to Financial Statements to Financial Statements for further information.

Equity in (income) loss of affiliated companies was a loss of $193 and $89 million in 2001 and 2000, respectively, and income of $67 million in 1999. Equity in (income) loss of affiliated companies included repositioning and other charges of $238, $136, and $43 million in 2001, 2000, and 1999, respectively. See Note 5 of to Financial Statements for further discussion of the repositioning and other charges. Excluding these charges, equity in (income) loss of affiliated companies was a loss of $474 and $415 million in 2001, 2000, and 1999, respectively. The decreases of $26 million in equity income in 2001 compared with 2000 was due mainly to the gain on the sale of our interest in an automotive aftermarket joint venture in 2001. The decreases of $155 million in equity income in 2000 compared with 1999 was due mainly to lower earnings from our UOP project technology (UPT) joint venture partially offset by the gain on the sale of our interest in an automotive aftermarket joint venture.

Other (income) expense, $17 million of income in 2001, decreased by $16 million in 2000 and $17 million in 1999. The decreases in selling, general and administrative expenses as a percent of sales in 2001 compared with 2000 principally reflected the impact of headcount reductions and a decline in discretionary spending for professional services, travel and overtime. The increase in selling, general and administrative expenses as a percent of sales in 2000 compared with 1999 principally reflected our acquisition of Pitney Bowes, which had a higher level of selling, general and administrative expenses as a percent of sales.

Environmental Matters

We are subject to various federal, state and local government requirements relating to the protection of the environment and safety in the workplace. We believe that, as a general matter, our policies, practices and procedures are designed to prevent unreasonable risk of environmental damage and personal injury to our employees and employees of our customers and that our handling, manufacture, use and disposal of hazardous or toxic substances are in accord with environmental laws and regulations. However, many because of past operations and operations of predecessor companies, we, like other companies engaged in similar businesses, have incurred remediation and voluntary cleanup costs for sites contaminated and are a party to lawsuits and claims associated with environmental matters, including past production of products containing toxic substances. Additional lawsuits, claims and costs involving environmental matters are likely to continue to arise in the future.

With respect to environmental matters involving site contamination, we continually conduct studies, individually of our owned sites, and jointly on a number of industry groups at non-owned sites, to determine the feasibility of various remedial techniques to address environmental matters. With respect to environmental matters involving the production of products containing toxic substances, we believe that the costs of defending and resolving such matters will be largely covered by insurance, subject to deductibles, exclusions, retention and policy limits. It is our policy to see Note 1 of to Financial Statements) to record appropriate liabilities for environmental matters when environmental assessments are made or remedial efforts or damage claim payments are probable and the costs can be reasonably estimated. With respect to site contamination, the timing of these estimates is generally no later than the completion of feasibility studies. We expect that we will be able to fund expenditures for these matters from operating cash flow. The timing of cash expenditures depends on a number of factors, including the timing of litigation and settlement of personal injury and property damage claims, insurance recoveries, regulatory approval of cleanup projects, remedial techniques to be utilized and agreements with other parties.

From Honeywell’s 2001 Annual Report and 10-K

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What changes did Sarbox bring about for the EHS Manager?

- The Act made no substantive changes to provisions of the SEC disclosure requirements that specifically address environmental matters.
- But the Act significantly changed the consequences of violations and provided new enforcement tools.
- Interested groups are applying additional pressure on companies to report environmental-related concerns.
Early applications of Sarbox in the Environmental Realm

- SEC, EPA and environmental groups are using Sarbox to require more extensive disclosure
  - Superfund liability
  - Enforcement proceedings
  - New/proposed regulations
  - Climate change issues

- Government Accountability Office (GAO) examined whether SEC is sufficiently policing corporate disclosure of environmental issues; EPA is enhancing enforcement action information-sharing with SEC and public
“GAO is recommending that SEC take steps to improve the tracking and transparency of information related to its reviews of companies’ filings, and to work with the Environmental Protection Agency (EPA) to explore ways to take better advantage of EPA data relevant to environmental disclosure. SEC agrees with GAO’s recommendations and is taking action by, for example, making comment letters and company responses available on its Web site, beginning with August 2004 filings.”

- From GAO’s website; Jul 2004 pub. GAO-04-808
Other pressures for environmental disclosure

- Friends of the Earth: *Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemical and Utilities Companies* (Sept 2002)
Other pressures for environmental disclosure (cont.)


Other pressures for environmental disclosure (cont.)

- Shareholder resolution initiatives
  - Example: Anadarko Petroleum Corp. (2005):
    “RESOLVED: Shareholders request that a committee of independent Board directors assess how the company is responding to rising regulatory, competitive, and public pressure to significantly reduce carbon dioxide and other greenhouse gas emissions and report to shareholders (at reasonable cost and omitting proprietary information) by September 1, 2005.”
  - 31% reportedly voted in favor of the 2004 resolution; 2005 resolution withdrawn
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<td>25</td>
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Source: May 10, 2005 report commissioned by CERES
Other pressures for environmental disclosure (cont.)

- Global Reporting Initiative and other voluntary reporting standards
  - According to GRI, 25 forest products companies use the GRI guidelines, including 5 US corporations, and at least 3 others with US operations.
What about forest products companies?

- Indicators suggesting lower pressure relative to other sectors
  - No emissions-reduction related stakeholder resolutions identified by ICCR in 2005 for forest product companies
  - AFPA: Managed forests remove the equivalent of 17% of GHG produced by the US; 60 percent of energy consumed is derived from renewable biomass
Sarbanes-Oxley requirements in the context of environmental disclosure

- Internal Controls
  - Burden on management to establish strong protocols to manage information flow for disclosure
  - For most companies, effective beginning with first fiscal year ending on or after November 15, 2004

- Whistleblower Provision
  - Federal offense with fine of up to 10 years for knowingly retaliating against whistleblower
  - Companies setting up anonymous electronic help-lines in response
Sarbanes-Oxley requirements and environmental disclosure (cont.)

- Document Destruction Provision
  - Seven year timeframe for documents supporting reports
  - Knowingly altering, destructing, concealing or falsifying documentation within jurisdiction of any department or agency of U.S leads to fine of up to 20 years
One forest products company’s experience with Sarbox and environmental disclosure

- Statement accuracy certification
  - Cascades down the line from CEO to corporate environmental staff
  - References SEC Form 10K
  - No untrue statements, no omission of material facts
  - Materiality disclaimer
One forest products company’s experience with Sarbox and environmental disclosure (cont.)

- Third-party verification of future predicted environmental costs (as opposed to permit records)
- Reevaluation of landfill closure costs when permit changes are made
One forest products company’s experience with Sarbox and environmental disclosure (cont.)

- Latest twist: FIN 47 - Accounting for Conditional Asset Retirement Obligations
  - Gives guidance on when one must record a liability for a future, conditional asset retirement (e.g., those related to PCBs, asbestos; effluent treatment system closures)
  - Closes the “insufficient data” loophole regarding the estimate of fair market value; effective 12/15/05
  - CEO.com: “Pollution Costs Returning to Balance Sheets”
The increasing acceptance of ISO14000 as a means of managing environmental responsibilities will have two effects, in light of Sarbox

- Those with ISO and ISO-like programs will rely on these programs to document fulfillment of due environmental diligence requirements
- Those without an EMS will be at greater risk unless a highly credible validation approach is implemented
But... is ISO14K enough for Sarbox?

- CEOs and CFOs must certify quarterly that the company has adequate disclosure controls and procedures.
- In EMS terms, most state-of-the-art EMSs will suffice, but some modifications will likely be necessary to make sure information goes up the last step of the management chain.
Revised Federal Sentencing Guidelines

- Revised federal Sentencing Guidelines issued November 1, 2004
- Enacted in response to Sarbox directive that the Sentencing Commission review and amend the federal Sentencing Guidelines to ensure that they are sufficient to deter criminal misconduct.
- Established seven requirements of an “effective” compliance program
1. **Established Standards and Procedures** -- Must establish compliance standards and procedures for organizational personnel that are reasonably capable of reducing the likelihood of criminal conduct.

2. **Oversight by Management** -- High-level personnel within the organization are assigned the duty of overseeing the compliance efforts.
3. **Exclusion of Individuals from Management** -- Due care is used to prevent delegating substantive responsibilities to persons who have a propensity to violate the law.

4. **Training Programs** -- Reasonable steps are taken to effectively educate and train employees and agents on their obligations under the program.
Sentencing Guidelines (cont.)

5. Monitoring Compliance -- Monitoring and auditing systems must be in place to detect and prevent violations of law, including a system whereby employees can report such violations within the organization without fear of retribution.

6. Discipline -- A mechanism for consistently enforcing discipline for compliance violations is in place.
7. **Responding to Criminal Conduct** -- After an offense has been detected the organization must take all reasonable steps to address the violation and put new or additional procedures in place to prevent it from happening again.
Suggested features of a technology solution for Sarbox compliance*

- Maintain the confidentiality of data submitted via electronic help lines (§301)
  - In keeping with Whistleblower provisions
- Ensure adequate records retention
  - Environmental records kept for 5 years? This ups to 7 years if the records support information reported to the SEC
- Meet best practices for electronic communications protocols and security

* Source: CompliancePipeline.com, 2/18/05
What you can do now

- If you do not have an enterprise EMIS solution
  - Understand the common benefits of many EMIS solutions in terms of information flow and disclosure
    - Compliance module that supports conversion of applicable requirements into actionable tasks
    - Escalation feature allows higher ups to know when compliance activities are left undone
    - Information “published” (reports, email), in addition to “made available” (URL to action log)
    - Audit feature allows tracking of information alterations – who changed what record when; annotation cells can be completed to explain why
What you can do now (cont.)

- If you do have an enterprise EMIS
  - Use the compliance module for its full intended purpose
  - Consider its use beyond environmental (health, safety, and other regulated elements)
  - Seek certification from a third party that all actionable applicable requirements are addressed in your compliance module; audit against these periodically
  - Involve your Sarbox audit committee; give them a username and password to see the amassed compliance record
Conclusions

- Sarbox ups the ante for environmental compliance and disclosure
- A state-of-the art EMS provides a good framework to provide the requisite information sharing
- The EMS must ensure that information makes it to the highest levels (to the certifying CFO/CEO)
- The diligent corporate environmental manager will evaluate his/her EMS in the context of Sarbox and make appropriate midstream adjustments
Acknowledgements and Sources

- Christopher McKenzie - Beveridge & Diamond
- Thomas M. McMahon - Sidley Austin Brown & Wood
- Kathy Blue, Trinity Consultants

Additional websites
- CERES – CERES.org
- Investor Network on Climate Risk – INCR.com
- Interfaith Center on Corporate Responsibility – ICCR.org
- AFPA – AFandPA.org
- CFO.com
Questions?

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