



# Closing Gaps in Traditional Environmental Due Diligence

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PwC explores how incorporating environmental, health and safety and corporate responsibility risks can achieve business goals

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Companies have been conducting Environmental Due Diligence (EDD) for over twenty years. In that period, the methodology and products have remained largely unchanged. However, transactions have become more complex, along with the drivers that shaped the original EDD methodology:

- Corporations and business transactions are more complex;
- Successful and fast integration is key to delivering value;
- The types of issues causing environmental risks and liabilities are more complex; and
- There are potential risks from a range of Corporate Responsibility (CR) issues.

The concept of EDD as a data-gathering exercise to protect buyers (and sellers) from acquiring (or retaining) liabilities such as contaminated properties is still necessary to protect a company from financial exposure. However, a company entering a transaction – divestiture, acquisition, joint venture, or service agreement – should focus on broader environmental, health and safety (EHS), and Corporate Responsibility (CR) issues that may affect the business goals of the transaction in order to avoid liabilities, manage risks, contain costs, successfully integrate businesses, and create value.

## Environmental due diligence today

Environmental risks have long been part of business and transactions. The familiar “Phase 1 Environmental Site Assessment (ESA)”, as outlined in the

American Society of Testing and Materials (ASTM) Standard E-1527, first published in 1993 and updated in 2000, is perhaps the most familiar US standard for EDD. This methodology was designed to gather data that would enable parties to make more informed decisions about environmental liabilities. In the US, requirements are imposed primarily by the Comprehensive Environmental Responsibility Compensation and Liability Act (CERCLA, or “Superfund”) of 1980, amended in 1986 by establishing an “innocent purchaser defence,” and by similar state statutes. The Small Business Liability Relief and Brownfields Revitalization Act of 2002 created additional landowner protections and an obligation for US EPA to establish ESA requirements under a new All Appropriate Inquiry rule.



However, requirements and guidelines governing the assessment/remediation of contaminated soil and groundwater are international in scope:

- International Standards Organization (ISO) 14015 – This 2001 standard addresses environmental assessments of sites and organizations, including potential multi-media impacts. It was developed as an international standard for multi-national corporations to aid in mergers, acquisitions and real estate transactions.
- European Union (EU) Environmental Liability Directive (2004/35/CE) – Establishes a legal framework to prevent and remedy environmental damage. Designed around the ‘polluter pays’ principle, it is applicable to contaminated sites, including water, land, protected species and natural habitats.
- European Regulations/Guidelines – Many countries have regulations governing contaminated sites, some in place for over a decade. Guidelines/methodologies for identification and investigation of these sites and national site inventories are available as well.

Even with rudimentary ‘Phase 1’ reporting, the necessities of business transactions, and the incremental nature of ESAs and remediation prevent parties from fully knowing or characterizing all environmental aspects prior to closing a transaction. Parties developed contrac-

tual provisions or simply assumed liabilities. However, traditional EDD only looks historically – it doesn’t consider how EHS or CR can affect the parties’ business objectives for the transaction.

**Critical questions could include (for a purchaser):**

- Can we obtain permits to increase production?
- Will we trigger or accelerate environmental clean-up or permitting requirements if we rationalize production among several facilities, close facilities, or change land use?
- Are there differences in financial reporting of environmental liabilities that would require adjustments to reserves, modifications of financial disclosures, or even restatement of earnings for previous accounting periods?
- How does compliance management compare between the two companies? Will changes in staffing, technology, or other resources be required?
- Does the other company use materials we have eliminated or contractors we have stopped doing business with or that we have pledged to our customers to avoid?
- Are there emerging issues, such as climate change, that will have a significant impact on the integrated company? Will this require capital investment, additional staff, or will it limit production?

Companies have conducted ESAs and remediation so that sites are better understood illuminating potential risks and liabilities. Other EHS/CR risks, however, are not as well understood, and their impact on companies is growing. How, then, should this be addressed as companies consider and complete transactions, and integrate operations?

**A new approach: applying COSO to EHS/CR transaction support**

As transactions unfold, business considering EHS/CR issues can benefit using a broader framework for internal controls and risk management. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) provides an established business framework to assess the effectiveness of internal controls. The COSO II framework, published in September 2004, provides an integrated framework for enterprise risk management (ERM) that is inclusive of the internal controls framework. Integral to these frameworks are three key business objectives: compliance, reporting (including financial), and operations.

The COSO framework can be applied to EHS and broader CR issues, just as it is for a corporation’s business activities. Each of these three COSO objectives includes elements of EHS/CR for historical, current, and dynamic issues that are relevant to a transaction.

**COSO II ERM framework**



## Compliance

**Regulatory:** Compliance with regulatory requirements is essential, complex (especially for global companies) and can include conformance with the following:

- Stipulated permit limits and/or reporting requirements;
- Written plans and procedures pursuant to regulations (e.g., contingency plans, preparedness plans);
- Facility configuration, materials, staffing, and other information provided in the permit application and/or included in pre-construction or operating permits; and
- Consent decrees with agencies for enforcement actions brought pursuant to regulatory non-compliance.

Since companies are increasingly global, they can be subject to requirements in countries outside their primary headquarters. For example, companies are considering the applicability of Sarbanes-Oxley for their US subsidiaries, operations and SEC registrants. Global companies with operations in the EU (and other specific territories) must meet obligations to reduce greenhouse gas (GHG) emissions under the Kyoto Protocol. Global transactions must consider these issues and the potential requirements.

**Other legal requirements:** Many companies identify and comply with other legal requirements, often on an ad hoc basis. EHS/CR examples may include:

- Indemnifications or warranties in previous sales or purchases of businesses;
- Contracts with landlords, lending and financial institutions;
- Service agreements with companies that operate cogeneration facilities, wastewater treatment plants, or maintenance facilities; and
- Health and safety responsibilities and requirements for contract workers.

These requirements can be more difficult to identify and assess due to the ad-hoc basis on which they are usually tracked, and particularly, if there are confidentiality provisions in place prior to closing a transaction. Companies should beware of the liabilities – or opportunities – that these requirements may pose.

### Company policies and commitments:

Companies vary in their approach to identifying and managing their commitments relative to CR. Examples may include:

- Conformance with industry trade association systems or standards (e.g., American Chemistry Council's Responsible Care or Edison Electric Institute's Environmental Excellence programs);
- Conformance with voluntary agency standards (e.g., OSHA Voluntary Protection Program);
- Commitments to customers, neighborhood associations, or employees, such as commitments by a facility manager to local residents to limit hours of plant operations to reduce noise levels;
- Commitments to stakeholder groups or adherence to their standards (e.g., Sullivan principles; Global Reporting Initiative (GRI) Reporting Guidelines or commitments to socially responsible investing (SRI) ratings agencies to avoid doing business in certain countries);

- Commitment to Companies' externally-stated or internal goals (e.g., reduce GHG emissions; adhere to Company standards worldwide).

These commitments require resources and may pose risks if they are not met. They can also influence the success, timing, and resources required to integrate and modify operations.

### Reporting and Disclosures

This COSO reporting objective can address both financial disclosures and reporting of non-financial information (NFI).

**Financial reporting:** Reporting requirements for reserves/provisions for environmental remediation liabilities, asset retirement obligations (AROs) and other legal liabilities can vary appreciably as can the procedures for calculating and reporting these disclosed amounts (e.g., US GAAP, International Financial Reporting Standards). Changes or trends in financial reporting (e.g., US Financial Accounting Standards Board Interpretation #47 (FIN 47), at the time of this publication, may require additional review and possible accruals to company balance sheets. Since company-specific application of new and existing accounting rules and guidelines can vary, this reporting may not consistently capture all 'probable and estimable' liabilities at the time of a transaction.

**Financial disclosure:** Companies disclose financial information relative to EHS/CR in their annual reports, 10Ks,



10Qs, 20Fs and other documents available to the public. This information can be used by investors and other stakeholders to determine current value and future performance of companies, as well as to hold them accountable for actually spending the monies as indicated. EHS/CR examples may include:

- Intended spending for emissions controls for SOx, NOx and/or GHG emissions; and
- Projected spending to address EHS/CR issues in supply chain management with respect to renewable energy use, human rights, or other areas.

If the two companies have different EHS/CR policies, programs, or relative financial commitments to EHS/CR, stakeholders may expect the merged company to achieve the higher standards.

#### Reporting of non-financial information (NFI)

Many companies – including most in higher-risk and higher-visibility industries – now engage in formal external reporting of EHS or CR performance. External reporting can include annual CR reports, information on company websites, and information and data provided on an on-going basis to customers, investors, trade associations, ratings groups and others external to the company. Such reporting can also be mandated based on country-specific requirements (e.g., UK banking industry, France). The demand for SRI has spawned a cottage industry of groups evaluating companies based upon their CR performance, both as published by the companies themselves and as reported by other watchdog groups. These parties rely upon the information's accuracy making decisions on investments, vendors, employment decisions – and whom to target for proxy or publicity campaigns.

#### Operations

Operations and compliance with EHS/CR requirements go hand in hand. Acquisition or divestiture of operations, and the attendant consolidation or expansion of same, can affect EHS/CR risks and opportunities, as follows:

- Retained, acquired or divested operations can materially affect the magnitude of environmental remediation liabilities;
- Consolidation or expansion of operations can affect facility operating permits, the need for permit revisions and associated facility operating constraints;
- Emission baselines can be affected, along with the ability to achieve emission reduction commitments and compliance requirements; and
- Reporting of NFI can become more challenging, especially if the veracity of systems, processes and controls is drastically different between the two companies.

#### Keys to success

With the complexity of business drivers, and CR risks and opportunities, EHS or CR support to transactions must evolve. No two transactions are identical, so effective EHS and CR support to transactions is not likely to reduce to a simple, standard methodology. What skill sets are advisable to achieve the most value? Parties to transactions will be served well by working with professionals who have a broad understanding of:

- Corporate Responsibility: implications of CR issues or opportunities beyond the traditional focus of EHS liabilities.
- The new face of “compliance”: sources and types of commitments that companies make that result in risks and opportunities beyond regulatory requirements.
- Financial reporting and disclosures: financial reporting and disclosures to maintain compliance and fully identify financial risks.
- Nature of business: the complexity of business and transactions and associated EHS or CR exposures and opportunities.
- Operations: their dynamics and how EHS/CR can affect and be affected by them.

Businesses must rise to the occasion as well. They must understand that the path forward may no longer be as simple as getting a report, cleaning up a site or obtaining a contractual provision. Trusted advisors with a broader range of experience can help avoid a broad range of CR liabilities and risks – and contribute to a successful transaction that can quickly capture synergies and value.

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