



## *The Enron debacle may prompt a re-examination of EHS governance ...Be ready*

*By Richard MacLean*

*Editor's Note: Due to the topical nature of this month's Manager's Notebook, the Strategic Planning article scheduled for this month will appear in our April issue.*

**E**nron is all about systemic governance failure. You can bet that directors and executives are now asking their staffs, "Where are we vulnerable?" These probes will not, however, be narrowly confined to Enron-type issues. Ideally, boards are staffed by strategic thinkers who probe far and wide, and environmental health and safety (EHS) is a recognized liability area that may come under much closer scrutiny. This article is a summary of the likely avenues that these inquiries may take and the possible fallout.

What is so significant about the Enron bankruptcy is that it is exposing problems within the entire governance system: so-called independent auditors bundling profitable consulting services; weak regulatory oversight and accounting standards; influence peddling in Washington; pressure on financial analysts to sell stock; legal consultants rationalizing away what amounted to corruption; and muted or ignored messages along the internal communication chain.

In some respects, Bhopal and Enron share a common theme: these disasters were so massive that they provoked fundamental changes in the way companies operate. Methyl isocyanate was not the defining concern in Bhopal any more than off-balance sheet debt is the sole issue today. After Bhopal, boards of directors reviewed the entire spectrum of risk management and community responsibility issues. An outpouring of internal policies and procedures resulted. Because the underlying problems were systemic to industry in general, new laws and industry initiatives, such as

Responsible Care®, also ensued.

### **How Might This Play Out for EHS?**

First, directors and business executives may raise concerns over EHS governance structures. For example, are the "independent" auditors also performing consulting services? Should the company that performs attestations of the EHS and community report also provide consulting services? If you are co-mingling external consulting services with the same companies providing audit services (a common practice), now may be the time to re-examine the strategy.

An even more significant issue is the internal reporting structure for EHS governance. In most companies, EHS governance and auditing are in the same group that provides EHS services. If audits are outsourced to a competent, truly independent consulting firm, this may not be an issue. But auditing — which largely addresses compliance issues — is not the same as governance, which focuses on assurance that the company's policies and systems are being implemented according to the instructions of the directors and business executives. This function should never be completely outsourced.

Governance should be budgeted through an overhead account and not controlled or viewed by the business units as an option. The push for shared services and outsourcing over the past six years created heartburn for many EHS managers when the governance function was treated as just another EHS service. EHS auditors in some companies have been literally told to go away when they showed up at uncooperative manufacturing facilities — which brings us to the next issue of potential concern — does the EHS governance function have the open communication lines and authority to

get their job done? In many companies that I have examined, it does not.

### **Dirty Secrets**

Strengthening organizational structural issues like those just described can be done relatively easy and quickly. Our second issue — what I call the really dirty secrets — can, and sometimes do, hit the bottom line.

In 1998, I co-authored a journal article on the top 10 recommendations for new EHS managers.<sup>1</sup> Number one on the list was "Perform a high level strategic risk review of all operations. Ensure that the officers of the corporation, the CEO and the Board will never be blindsided by significant, unanticipated issues." Experience had taught my two seasoned EHS co-authors and me to *always check first for the dirty secrets*.

Corporate, business group and manufacturing managers almost always believe that they have an excellent understanding of their issues. Indeed they may, but if you do not independently verify current status using *very senior talent* working in conjunction with internal staff, you may be operating in a place we call La-La-Land. It is a fog-covered realm of self-denial and rationalization.

I can recall one new position in which my predecessor asserted to management that he had everything under control. Within two months I had uncovered a string of significant liabilities — stuff so significant that the board of directors had to be told at the next meeting. There was the usual assortment of property contamination issues and abhorrently poor risk management practices, but the one that really took the prize was a missing permit for a key unit upon which an entire facility depended.

Many years prior to my arrival, an outside lawyer wrote an opinion (using convoluted

logic that amazes me to this day) that the unit did not need a permit. Since executive management at the time did not want to go through the hassle of obtaining a permit, his "expert legal opinion" was embraced with open arms (and a hefty fee). The esteemed friend of management, however, did not know his *gluteus maximus* from his *articulatio cubiti* (Author's note: I used the Latin terms since he was, after all, a lawyer.) And, get ready...no one bothered to check with the regulatory agencies which, of course, had the ultimate say and the power to shut down the facility. Ceasing operations for just one day would have cost the company millions of dollars.

The point of the example is that EHS staffs can be lulled into thinking that all is well. Indeed, they can rationalize away real issues — grasping, for example, legal arguments from outside experts (recall Enron's Arthur Anderson and Vinson and Elkins, Anderson's Houston-based legal counsel). Worse yet, they can be intimidated by management to go with the flow and group think; to spin only the positive (again, Enron and the financial analysts).

The pressure on some EHS managers is real. It can take the form of a wink, "We really do not need to investigate this allegation of contamination too extensively — *Right?*" and a nudge, "This is so fuzzy; we

really cannot quantify or time its impact — *Right?*" Some of the more popular winks and nudges are listed in Table 1.<sup>2</sup> Welcome to the La-La-Land of rationalization.

### Table 1. Top Ten Ways to Rationalize Away Liability

10. The cost estimates are not precise and can vary tremendously.
9. There is no clear line between what you: (1) should; (2) must now; (3) would like to; and (4) may *someday* be *required* to do to remediate.
8. We are following current industry practice.
7. Regulations and liability issues change with time.
6. The extent of an issue is generally not known until long after the initial concern is raised.
5. The timing can vary tremendously; both past and future events are involved.
4. "Materiality" is not precisely defined and can include subjective factors that may influence the *perceived* value of the company to shareholders.
3. EHS cost estimation is an area in which accountants have limited expertise or professional organizational guidance.
2. There is no universally recognized environmental accounting system to roll up the liabilities.
1. There is no pressing urgency or requirement to quantify the liability.

### Awareness of Accounting Loopholes

Companies have used all this confusion and uncertainty as the justification (rationalization) for not disclosing very much information (i.e., Table 1 in action). It is relatively easy to avoid reporting liabilities and booking reserves by hiding behind narrowly defined regulations.<sup>3</sup> The companies that have been more open in their disclosures have done it out of company policy considerations, rather than regulatory requirements or fear of enforcement. For example, rarely in the past 20 years has the U.S. Securities and Exchange Commission (SEC) enforced failures in environmental accounting procedures (generally accepted accounting principles (GAAP) requirements).<sup>4</sup>

Organizations such as the Corporate Sunshine Working Group have raised concerns over EHS information disclosure for more than a decade.<sup>5</sup> Even the *Wall Street Journal* joined in with a 1988 front page story "Can \$100 Billion Have No Material Effect?" The article reported the general trend in industry to underreport environmental liability issues on their 10-K reports.

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Historically, however, very few publicly traded companies have gone bankrupt because of EHS problems. Major spills or class action lawsuits have created a number of highly visible, notable exceptions. In the past, one could argue that existing EHS disclosure requirements have been adequate. After all, the few exceptions were extensively covered in the media as the problems evolved. In spite of the SEC's rosy outlook, however, the controversy continues to grow.

In a 1999 *Harvard Law Review* article, Law Professor Cynthia Williams concluded that the SEC has both the duty and the authority to demand greater EHS disclosure. The SEC has taken little substantive action over the past three years; but the political pressure may now mount to close loopholes that allow companies to keep certain EHS liabilities off the books.

The staggering impact of company bankruptcies due to asbestos litigation may be another impetus for change.<sup>6</sup> Already, the banking community gives little credence in the 10-K reports to environmental liabilities when considering loan applications. Even if the SEC drags its feet, company boards of directors may be more sensitive to these EHS governance issues and self-initiate change.


## Conclusion

Enron's debacle will keep the issue of corporate governance on management's radar for months to come. There is nothing more

sobering to directors than media reports of their colleagues being led off to prison or being stripped of their assets. I am recommending that my clients take a close look at their governance systems before the word comes down from above. You might consider doing the same.

If you are new on the job, you have a major advantage in that the dirty secrets that may be lurking about are not ones that you created or overlooked on your watch. If you have been in your current position for a year or more, sorry, they are all yours. Moving from the fog of La-La-Land into the sunshine is never easy. In fact, if not handled correctly it can be a one-way ticket to the

unemployment line.

So how do you do this? *Very carefully.* I'll cover some of the basics in an upcoming Manager's Notebook. 

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## References

- <sup>1</sup> R. MacLean, D. Bowers and W. Sugar, "Leading Successful Environmental, Health and Safety Organizations - Ten Recommendations for EHS Executives," *Corporate Environmental Strategy*, Winter 1998, v5n2, Pages 4-13.
- <sup>2</sup> Also see a related story on the issue of underreporting of financial disclosure by R. MacLean, "Synchronicity - Formulating an Integrated Disclosure Strategy," *Environmental Protection*, January 2002, pages 36-39.
- <sup>3</sup> See for example, *Wall Street Journal*, "When Rules Keep Debt Off the Books," January 18, 2002, page C1
- <sup>4</sup> "Enviros Go After the SEC on Non-Disclosure," EHS Management, The Environment Group, Inc., New York, New York, September 1997.
- <sup>5</sup> <http://www.foe.org/international/cswg/>
- <sup>6</sup> Review & Outlook, "The Job-Eating Asbestos Blob," *Wall Street Journal*, January 23, 2002, Page A22.

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