A looming environmental Enron?

Could a recent pronouncement by the US Financial Accounting Standards Board (FASB) see major corporations collapsing under the weight of undisclosed environmental liabilities? **Greg Rogers** considers the arguments

It's enough to send shivers down the spines of corporate executives: a recent article in a US trade publication warned that "disclosure rules presage environmental Enron," quoting a leading environmental campaigner*. The article described a March 2005 FASB pronouncement, known as FASB Interpretation No 47.

FIN 47, which becomes effective in 2006, addresses the accounting treatment of so-called conditional asset retirement obligations (CAROs) – most commonly exemplified by environmental disposal and clean-up obligations associated with a company's owned assets. In the past, US accounting standards have not mandated liability recognition for such obligations in the absence of pending or probable future legal action.

Now, however, liabilities for environmental CAROs must be recognised, regardless of the likelihood of future governmental enforcement or private litigation and even though management might believe the company can delay settlement of such obligations indefinitely.

The FASB pronouncement – which applies to all public and private businesses subject to US generally accepted accounting principles (GAAP) – marks a dramatic shift in accounting treatment for environmental liabilities. For the first time, companies are expected to report likely future environmental clean-up and disposal costs for commonplace circumstances such as underground petroleum storage tanks, asbestos-containing materials in buildings, and soil and groundwater contamination.

At this point, no one can accurately estimate the magnitude of the global environmental clean-up obligations for US reporting entities. However, extrapolating from the estimated $10 billion in environmental costs to plug and abandon oil and gas wells in the Gulf of Mexico, the numbers could easily run into the hundreds of billions of dollars.

So does FIN 47, or the failure to comply with it, represent a looming accounting scandal of the order of Enron? There are valid reasons to be concerned:

☐ *Fair value measurement and Sarbanes–Oxley.* Not only must companies report previously undisclosed CAROs, they must measure these liabilities at 'fair value', limiting the flexibility to low-ball estimates. Moreover, Sarbanes–Oxley requires independent financial auditors to verify that public companies have appropriate controls and procedures to identify, assess, measure and report CAROs.

☐ *A history of "don't ask, don't tell".* To defer environmental clean-up costs, many US companies have fastidiously avoided activities such as commercial transactions that might trigger government intervention. Consequently, in addition to unreported clean-up obligations associated with active production facilities and waste management units, many US companies maintain large inventories of contaminated mothballed facilities. The closet is full of skeletons.

☐ *Off-balance sheet environmental liabilities will affect solvency.* Full accounting for environmental CAROs will negatively affect the balance sheets of many companies, causing some to become technically insolvent. This will in turn have other ripple effects, such as violation of debt covenants, fraudulent conveyances, unlawful dividends and breach of fiduciary duties by corporate directors.

☐ *Increased accountability.* Regulators are demanding greater financial assurance for environmental clean-up obligations. A week after the mining company Asarco filed for bankruptcy in August 2005 with an estimated $1 billion in unfunded clean-up costs, US congressional investigators released a report warning that other companies might take similar action to shed environmental responsibilities and leave taxpayers liable for billions in remediation costs. Financial assurance for clean-up obligations is now an enforcement priority for the US Environmental Protection Agency.

Could accounting changes unlock the gates to massive clean-up costs?

FIN 47 promises to expose the environmental bankruptcy of many US reporting entities. But there are several reasons why evidence of accounting scandals comparable to Enron may not materialise:

☐ *CAROs are non-cash items.* FIN 47 can require recognition of environmental CAROs long before a company expects to settle these obligations by actually performing a clean-up. While FIN 47 may tarnish a company's balance sheet, it has no direct effect on current cash flow.

☐ *CAROs don't all hit at once.* Individual CAROs will often be immaterial standing alone. And, while the aggregate amount of hundreds or thousands of CAROs may be large, a company is unlikely ever to be required to settle all of its CAROs at one time.

☐ *CAROs have a limited impact on earnings.* Reserves for CAROs are not immediately charged to earnings. Rather, estimated future clean-up costs are charged to income over the remaining useful life of the contaminated asset. The gradual allocation of CAROs to earnings reduces the risk of a sudden shock to Wall Street.

☐ *A change in accounting principles is not fraud.* FIN 47 represents a revolutionary change in accounting for what were previously off-balance sheet environmental liabilities. Some will argue that companies should have disclosed these liabilities long before FIN 47. However, if companies prospectively comply with the letter and spirit of FIN 47, it would seem improper and ineffective to accuse them of past fraud, *à la* Enron.

In conclusion, FIN 47 is ushering in a new era of environmental transparency. Companies that embrace the change will avoid future accounting scandals and find ways to exploit new opportunities. Environmental Enron, however, may await those companies with vast undisclosed environmental legacy liabilities that fail to grasp that it is best to disclose what you can no longer conceal.

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* 'New FASB Rule Spurs Brownfield Spin-Offs, Write-Downs', *Inside Counsel*, September 2005, quoting Michelle Chan-Fishel of Friends of the Earth