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Firms Must Be Mindful of Assets' Environmental Obligations

By Catherine W. Johnson

Last year, the Financial Accounting Standards Board issued a new accounting standard for recognizing liabilities known as CAROs — conditional asset retirement obligations. Financial Accounting Standards Board Interpretation Number 47, Accounting for Conditional Asset Retirement Obligations, 2005 (FIN 47), is effective no later than the end of fiscal years ending after Dec. 15, 2005 (Dec. 31, 2005 for calendar-year entities).

Financial Accounting Standards Board standards and other standards, including FIN 47, comprise generally accepted accounting principles, which are recognized as authoritative guides for financial reporting practices by both public and private companies. Under FIN 47, companies will need to disclose and report liabilities that may not be incurred for years down the road, if ever. Many companies have never had any reason to identify or quantify these future liabilities. According to FIN 47, however, "an entity shall identify all its asset retirement obligations." Although it is not clear how far this obligation extends, companies will at a minimum need to identify and track known conditional asset retirement obligations.

Some companies have already been spending significant time and resources on a FIN 47 compliance program. Other companies are only now beginning to focus on FIN 47. Because multiple and complex environmental laws and accounting principals are implicated — and identification of conditional asset retirement obligations may take time — companies who must comply with FIN 47 should implement a FIN 47 compliance program in the near future if they have not already done so.

FIN 47 interprets and clarifies the scope of Financial Accounting Standards Board Statement No. 143, Accounting for Asset Retirement Obligations, 2001, a standard addressing asset retirement obligations effective for fiscal years beginning after June 15, 2002. Statement 143 requires that the fair value of asset retirement obligations must be recognized in the period in which the obligation is incurred when the fair value can be "reasonably estimated."

Asset retirement obligations are legal obligations associated with the retirement (for example, sale, transfer or abandonment) of certain assets (such as equipment building or property). Legal obligations include laws, regulations, contractual obligations and even obligations arising under the doctrine of promissory estoppel (a company makes a promise to the public about the disposition of property, for example).

Examples of an asset retirement obligation are closure and post-closure requirements applicable to owners and operators of solid or hazardous waste landfills taken out of service (such as monitoring landfill gases and leachate). Contaminated property may also be treated as an asset retirement obligation. Standard 143 explains that where contamination is inherent in normal operations of the facility, the obligation may be an asset retirement obligation, whereas if the contamination is the result of a catastrophic accident, the contamination is not within the scope of Standard 143 (but should be evaluated under Standard 5, Accounting for Contingencies, 1975).

Most companies had assumed that Standard 143 did not apply to asset retirement obligations when the timing or method of "settlement" (the realization of the obligation) is conditional on one or more future events. According to FIN 47, however, conditional asset retirement obligations must be recognized when they can be reasonably estimated (and materiality thresholds are otherwise met).

Although conditional asset retirement obligations are not limited to environmental liabilities, all of the illustrative examples provided in FIN 47 pertain to environmental liabilities — and the most obvious asset retirement obligations are environmental laws that impose closure requirements on permitted units or disposal requirements of certain equipment or materials.

For example, under federal and state law, asbestos-containing materials must be removed before a building is demolished (or when the material is otherwise disturbed). Thus, if a company owns a building with asbestos-containing materials, it owns an asset with a retirement obligation (for example the requirement to abate the asbestos-containing materials).

According to FIN 47, the ability of the company to defer the demolition of the building does not relieve the entity of the asset retirement obligation "because no building lasts forever," meaning the asbestos must ultimately be disposed of and handled in a special manner at some point. FIN 47.

Moreover, according to FIN 47, selling the building does not relieve the entity of its present responsibility to settle the obligation because the sale would transfer the obligation to another entity and that transfer would affect the selling price. Thus, FIN 47 assumes that the cost of asbestos abatement is factored into the sales price of commercial or industrial buildings (which may not be the case in a given sales transaction) meaning the obligation is realized at the sale if it is not realized at demolition. According to FIN 47, a conditional asset retirement obligation may be reasonably estimated when it is evident that the fair market value of the obligation is in the acquisition price, an active market exists for the transfer of the obligation or sufficient information exists to apply an expected present value technique.

Sufficient information is available to apply an expected value technique if the settlement date and method of settlement have been specified by others; or information is available to reasonably estimate the settlement date or the range of potential settlement dates, the method of settlement or potential methods of settlement, and the probabilities associated with the potential settlement dates and potential methods of settlement. An entity's past practice, industry practice, or management intent are relevant indicia of potential dates and methods of settlement.

FIN 47 provides several examples to demonstrate when a company has sufficient information to reasonably estimate the fair value of asset retirement obligations. According to one example, a company acquires a factory with asbestos-containing materials but insufficient information is available at the time of acquisition to reasonably estimate the retirement obligation; several years later, however, the company learns that demand has fallen for the products produced by the factory (and thus presumably information about the operating life of the factory is available). According to FIN 47, at the time the company learns about decreased demand for the products produced by the factory, the company has information about the range of potential settlement dates, the potential methods of settlement, and the probabilities associated with the potential settlement dates and potential methods of settlement.

Even if a conditional asset retirement obligation cannot be reasonably estimated, it must be disclosed. FIN 47 directs that disclosure should include a description of the obligation, the fact that a liability has not been recognized because the fair value cannot be reasonably estimated, and the reasons why fair value cannot be estimated.

The process of identifying conditional asset retirement obligations and evaluating recognition and disclosure requirements will differ from company to company, depending on company assets, industry sector, and business practices. Companies in heavily regulated industries or industries involving the use of hazardous materials or equipment may need to establish a comprehensive audit program. Even companies that do not use hazardous materials and hold few tangible assets, however, may own real property with features that may constitute conditional asset retirement obligations such as asbestos-containing material, lead-based paint and heating oil tanks.

A review of pre-acquisition environmental site assessments for real property owned by the company may not be sufficient to identify conditional asset retirement obligations associated with the property. The industry standards for pre-acquisition environmental due diligence — ASTM (American Society for Testing and Materials) E1527-05 and the new "all appropriate inquiry" rule published by the U.S. Environmental Protection Agency, 40 Code of Federal Regulations Part 312 — are designed to protect buyers from cleanup liability, not to identify other types of environmental liabilities or conditional asset retirement obligations.

Many companies supplement the American Society for Testing and Materials environmental due diligence standard to include an investigation for asbestos-containing materials and lead-based paint; however, even this expanded investigation may not necessarily flag all potential conditional asset retirement obligations. Relatively benign features, such as septic systems and water wells, may have retirement asset obligations, but would not necessarily be identified in an environmental report intended to identify significant environmental liabilities.

Moreover, conditional asset retirement obligations can also be contractual obligations, which would not ordinarily appear in due diligence documents. For example, an option agreement may obligate a landowner to remove certain realty or fixtures if the prospective buyer exercises the option to purchase. Finally, some conditional asset retirement obligations can be identified only after review of applicable federal, state, local, or regional laws. For example, some cities have special handling requirements for lead-based paint before demolition activities can commence – and some local governments impose closure requirements on underground storage tanks beyond federal or state requirements.

Companies should also begin evaluating how they intend to track new conditional asset retirement obligations. For example, when acquiring assets (such as equipment or real property), some companies may want to have a pre-acquisition evaluation of conditional asset retirement obligations so they understand the impact the purchase will have on financial statements.

Some companies may also want to ask their environmental consultant to include an investigation of conditional asset retirement obligations as part of pre-acquisition due diligence for real property. Because, however, conditional asset retirement obligations may include assets not typically associated with environmental liabilities, and because consultants may not be aware of all laws applicable to certain assets (environmental or otherwise), the environmental due diligence report should also be reviewed by an accountant, lawyer, or consultant who has expertise in the area.

To adequately investigate potential and existing conditional asset retirement obligations, companies should be prepared to consult with qualified professionals and develop a coherent and comprehensive plan. To minimize future costs, the plan should include an approach for handling such inventories in subsequent years as the fair value for certain asset retirement obligations may need to be modified from year to year, and assets may need to be added or deleted from the original list of conditional asset retirement obligations as they are sold or acquired.

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