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A New Chapter in Accountancy Standards

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At the heart of accountancy practice and stock market investment lies the principle of corporate disclosure of audited information on which investors can rely as giving a fair and accurate description of the financial state of a company. This principle of audit and disclosure of value is of particular importance in respect of contingent liabilities, which are difficult to quantify accurately but which may, if not professionally audited and disclosed fully as liabilities, distort the true value of a company.

Historically, the financial assessment of the costs of contingent liabilities was not addressed by the accountancy profession with the same degree of exactitude as present tangible assets or liabilities. There is, however, a growing awareness among businesses, the accountancy profession, regulators and shareholders of the need for all liabilities, including contingent liabilities, to be accurately estimated and disclosed.

Of all forms of contingent liabilities, environmental liabilities, closely followed by product liabilities, are arguably of pre-eminent importance in determining the value of investments, companies and assets. And, in a number of different jurisdictions, measures being introduced are leading to an increasing need for companies to take account of their environmental impacts from an accounting perspective.

As a consequence of these changes in accountancy standards in respect of environmental disclosure, affected companies will be required to carry out more detailed and more general environmental due diligence and environmental auditing to obtain relevant environmental information and cost estimates of environmental liabilities. Where appropriate, this will include seeking advice from external accountancy firms, environmental consultants and environmental law and other legal experts.

In the US, the introduction of Financial Accounting Standard Board (FASB) Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations (FAS 143), although not specifically designed for addressing this purpose, has been of central importance to companies' accounting for and disclosure of environmental liabilities.

FAS 143, which was published in June 2001, requires the recognition of an Asset Retirement Obligation (ARO) at fair value when incurred. It also requires the disclosure of AROs in Securities and Exchange Commission filings. FAS 143 has been reinterpreted and further regulated by FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47, which took effect from December 2005), which clarifies, in part, how to recognise conditional asset retirement obligations (CAROs).

FIN 47 requires companies to disclose AROs, even if cost or timing uncertainties exist that make cost estimation difficult. For example, the obligation to remove asbestos-containing materials prior to demolishing a building must be reported as a liability at the present time even if the owner of the building has no current plans to demolish it.

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The effect is that, as soon as companies know that they will eventually have to pay costs to retire an asset, an estimate of the fair value of those future costs has to be made. This must be recorded on the balance sheet as a liability. If companies cannot reasonably estimate the fair value of an ARO, typically because of the inability to determine potential settlement dates, they must nonetheless disclose the existence of the obligation and the reason why a reasonable estimate cannot be determined.

FIN 47 further addresses how companies should account for any future legal obligations they may face to dispose of assets carried on their books. This could include cleaning up environmentally damaged properties or getting rid of hazardous materials. This represents a revolutionary expansion in the scope of environmental obligations deemed to be liabilities.

Canada has followed the US lead. The Canadian Institute of Chartered Accountants Handbook Section 3110, Asset Retirement Obligations, also addresses financial accounting and reporting for obligations associated with retirement of tangible long-lived assets and for the associated asset retirement costs.

In the UK and the rest of Europe, progress has been less marked. However, the 2003 EU Accounts Modernisation Directive states that listed and large unlisted companies must provide a balanced and comprehensive analysis of the development, performance and position of the business (''Business Review'') in their annual reports. Such information should not be restricted to financial information and it is expected that, where appropriate, this should lead to an analysis of environmental and employee aspects necessary for people to gain an understanding of the company's development, performance or position. Although some EU states, for example Italy, have not yet completed transposition of the Directive, implementation is taking place throughout the EU.

Another important provision of the Accounts Modernisation Directive relates to the requirement for companies to abide by International Accounting Standards, set by the International Accounting Standards Board (IASB). On 2 December 2004, IASB's interpretive arm, the International Financial Reporting Interpretations Committee (IFRIC), issued IFRIC 3. IFRIC 3 contains guidance on accounting for greenhouse gas emissions, which specifies the accounting for companies participating in government schemes aimed at reducing emissions.

This requires companies to account for the emissions allowances they receive from governments as intangible assets. These are to be recorded initially at their ''fair value''. Further, IFRIC 3 establishes that companies, as they produce emissions, should recognise a liability for the obligation to deliver allowances to cover those emissions. These are to be valued at the end of the compliance period at the market value at that time. On September 2005, IASB started work on new accounting rules for emissions trading, focusing on how allowances/credits will be accounted for and how changes in value of assets and liabilities should be reported.

As of April 2005, UK company law requires that all public and large private companies include relevant environmental information in a business review under voluntary Key Performance Indicators (KPI) as part of their annual report and accounts. Pursuant to Financial Reporting Standard (FRS) 12 (Provisions, Contingent Liabilities and Contingent Assets), companies must disclose in their annual accounts the financial impact of certain

environmental liabilities, including contingent obligations under pending regulations plus the amount and circumstances surrounding them.

Furthermore, under FRS 10 (Goodwill and Intangible Assets), all UK registered companies must account for tradable emissions permits as intangible assets in accordance to international standards. Finally, in accordance with FRS 11 (Impairment of Fixed Assets), all UK companies must account for changes to asset values that stem from environmental factors where the company considers such factors to be financially material. Therefore, the EU Emissions Trading Scheme should increase reporting since allocations are now considered assets and should be revalued over time as their fair value (defined in reference to their market price) changes.

So what have been the effects of these developments in environmental accounting? Although it's too early for a full assessment of the US experience, preliminary research shows that, in the fourth quarter of 2005, FIN 47 cost corporate America more than $1 billion (comprising internal and external management time, monitoring, and implementation)[1]. Reports filed after the effective date prompted the recording of FIN 47 liabilities by at least 43 companies where none had been reported previously. Further, a review in March 2006 of 166 public filings in the two previous months by companies whose revenues were above $500 million found that "the aggregate financial statement impact of FIN 47 on these sampled companies was in excess of $2.2 billion but that across (and within) industries, the impact varied from no effect to quite substantial"[2].

These variations are evident in the reporting of companies of comparable size, in the same sectors[3]. For example, in the aerospace industry, Boeing reported a $4 million financial impact on annual revenue for 2005 of $54.000 million, while Honeywell International reported a $21 million liability, despite having annual revenues of $27,700 million in the same year. Equally, in the power sector, Wisconsin Energy – with an annual revenue of $3.800 million company in 2005 – reported a $38.4 million FIN 47 liability, compared with El Paso, who considered FIN 47 as "immaterial" to its $4,000 million revenue in the same period of time.

In the meantime, corporations are also investigating creative alternatives to their long-held risk management strategies. These include selling off their non-productive and fenced-off properties; using environmental insurance solutions; carrying out sales and leasebacks of real estate in order to pass the obligation to report FIN 47 liability onto the buyer/lessor's balance sheet; and choosing clean-up and redevelopment of their own sites, preferring to maintain control over long-term land use as a means of limiting future liability exposure[4].

Moreover, companies are also applying, where feasible, environmental insurance solutions, utilizing cost cap policies (that cap environmental clean-up costs) and/or pollution legal liability policies (covering unknown cleanup costs, and third parties claims for property damage and bodily injury) which can transfer or significantly mitigate uncertainty.

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1 Gregory Rogers, *If Your Head is in the Sand, Your Assets are Exposed*, Brownfields.com 18, 18 (June 2006).

2 Tammy Whitehouse, *Short on Clarity, FIN 47 Sows Confusion Compliance Week*, 29 August 2006 and Corporate Executive Board, The Impact of FIN 47 (So Far), March 2006 (concluding that financial statement impact and FIN 47 resource consumption varies widely across companies, and that not all companies are estimating the value of identified CAROs at p. 1).

3 *Id.*

4 Gregory Rogers, *supra* note 1 at 19.

One further development to be followed will be the impact of FIN 47 on US subsidiaries worldwide. While it appears that there are no legal obligations requiring companies to report CAROs at international facilities, the practices used by those companies that prepare and disclose detailed reports is likely to establish ''best industry practice'' and alert shareholders and auditors to whether or not companies are not disclosing AROs (and if they are not, lead them to question whether such companies are in full compliance with their obligations).

For the moment, particularly in European countries, greater attention will need to be given to potential risks and liabilities as a result of climate change legislation and litigation. The implementation of the 2004 Transparency Directive is likely to increase companies' and directors' liabilities as to the accuracy of their reporting obligations. Further, the Environmental Liability Directive, which will be transposed at the latest by 30 April 2007, is expected to have significant impacts on liability for losses of biodiversity which has so far been almost entirely unregulated.

Moreover, there can be little doubt that the impact of FIN 47 and other accountancy standards will be felt in Europe and that, sooner or later, EU standards similar to North American ones will be adopted by member states. Meanwhile, we watch with interest the problems faced in the US of bedding in FIN 47 and obtaining consistent information on AROs and CAROs to enable a fair comparison of the available data.