

*New Accounting Standard will have Far-reaching Consequences for
Environmental Disclosure*

[LAWRENCE P. SCHNAPF](#)
[Schnapf Environmental Law Center](#), New York, NY

Since the United States Security and Exchange Commission (SEC) first established environmental reporting obligations under [Regulation S-K](#)¹, many companies have relied on standard accounting practices to delay and disclosing potential remediation costs associated with historical contamination or future closure obligations. However, a new far-reaching accounting standard that went into effect on December 15, 2005 may dramatically alter the way many companies record and report environmental liabilities. As a result, many companies that “mothball” or “warehouse” corporate properties may find themselves have to adjust their financial statements to reflect previously undisclosed costs of remediating certain types of facilities and equipment.

FASB 143

On March 30, 2005, the Financial Accounting Standards Board (FASB) issued [Financial Interpretation No. 47](#), “*Accounting for Conditional Asset Retirement Obligations*,” (FIN 47) which clarified certain requirements set forth in FASB’s 2001 [Statement No. 143](#) “*Accounting for Asset Retirement Obligations*” (FAS 143). FIN No. 47 became effective on December 15, 2005 for companies using fiscal year accounting and December 31, 2005 for companies with calendar accounting.

FAS 143 was developed in 2001 to provide uniformity in how companies evaluated asset retirement obligations (ARO). FAS 143 applies to “legal obligations”

¹ 17 C.F.R. 229. The SEC environmental reporting requirements are set forth in Regulation S-K Items 101, 103 and 303. In 1989, the SEC clarified the environmental disclosure requirements in Securities Act Release (SAR) 6835 (49 Fed. Reg. 22,427, May 24, 1989). In addition, Staff Accounting Bulletin No. 92 (SAB 92) provided further guidance on identifying and reporting contingent environmental losses (53 Fed. Reg. 32,843, June 14, 1993). SAB 92 was subsequently re-codified within SAB 103(68 Fed. Reg. 26,839, May 16, 2003).

associated with the retirement of tangible long-lived assets such as property and equipment. The term “retirement” means the sale, abandonment or disposal of a long-lived asset and does not apply to the temporary removal or idling of the asset.

Prior to the adoption of FASB 143, [FASB Statement No. 5](#) “Accounting for Contingencies” (FAS 5) was the principal tool used to evaluate environmental liabilities. FAS 5 requires entities to recognize losses when it is “probable” that asset is impaired, the loss is “reasonably estimable”, and the liability is material. The “probable” prong of the FAS 5 test has generally been interpreted to mean “more likely than not to occur”. However the second prong, “reasonably estimable”, has proved difficult to apply to environmental liabilities, since cleanup costs may dramatically change depending on the amount of information available about the extent of the contamination and whether a remedy has been selected. [FAS 14](#), in turn, indicated that loss contingences under FAS 5 should be recognized at their “most likely value”. When the loss is a range where no amount is a more accurate estimate than any other amount, FAS 14 provides that the lowest amount in the range should be used with is known as the “Known Minimum Value” standard to provide guidelines on estimating contingent environmental liabilities. This [ASTM E2137](#) “Standard Guide for Estimating Monetary Costs and Liability for Environmental Matters” indicates that cost estimates should be expressed in terms of expected value, most likely value, range of values and known minimum value.

Because companies have frequently used this uncertainty to either delay potential environmental liabilities, the AICPA issued its [Statement of Position 96-1](#), “Environmental Remediation Liabilities” (SOP 96-1) that provides guidance on when

environmental liabilities should be accrued and benchmarks for determining when environmental liabilities should be recognized.

FAS 143 rejected the “probable and reasonably estimable” approach of FAS 5 in favor of a fair value measurements (FVM) when calculating AROs. Under FAS 143, AROs must be recognized when the liability is incurred which is generally when the long-lived asset is acquired, constructed, developed or through normal operation provided the company can make a reasonable estimate of the “fair value” of the liability. There are five levels of hierarchy for calculating fair value. An entity must begin at the highest level and may work its way down if sufficient information is unavailable. The highest and preferred FVM is quote prices from active markets with the lowest being assumptions developed by the entity. As explained in FAS 143, FIN 47 and a June 2004 FVM Exposure Draft, the best measure of fair value is the price that would be paid to transfer the environmental liability in an arm’s-length transaction between marketplace participants. Fair value does not apply to transactions involving distressed sales or liquidations. If quoted market prices are not available, fair value can be estimated based on the best information available in the circumstances, including prices for similar liabilities and the results of expected present value or other valuation techniques. The FVM Exposure Draft initially adopted the longstanding “undue cost and effort” test that would allow an entity to use a less rigorous measurement technique when calculating fair value in the event that using a more rigorous valuation technique would require “undue cost and effort”. However, in June 2005, FASB explicitly rejected the “undue cost and effort” test. As a result, an entity will generally have to collect more data and perform

more analysis for a FVM estimate than “best estimate” and “known minimum value” approaches acceptable under FAS 5.

FAS 143 and FIN 47 apply to “legal obligations”. This term is defined as “an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract, or by legal construction of a contract under the doctrine of promissory estoppel.” Under FAS 143 and FIN 47, liability has three characteristics. The first characteristic is that the entity has a “present duty” or responsibility to one or more entities that must be settled at a specified or determinable date, by the occurrence of a specified event or on demand. The second characteristic is that the duty or obligation must obligate the entity so that it has little or no discretion to avoid the future liability. Finally, the obligating event must have already occurred. FAS 143 acknowledges that it may be difficult to identify an obligating event in some situations. For example, an entity may obtain a license or permit that contains closure or decommissioning obligations. However, while the underlying law or permit may create a duty, the obligating event is the contamination since there would not be any closure obligation in the absence of the contamination.

FAS 143 also applies to partial settlements of AROs. For example, an entity that owns or operates a landfill is required to periodically cap waste cells as they become full but does not have to perform closure or post-closure until the entire landfill ceases operation. In this scenario, the capping obligations fall within the scope of FAS 143 and must be included in the measurement of the asset retirement obligation. Likewise, an entity that acquires an operating landfill will have to comply with FAS 143 for the remaining obligations associated with the landfill. Similarly, decommissioning costs

associated with nuclear power plant are legal obligations resulting from normal operations and therefore subject to FAS 143.

However, remediation costs resulting from the improper operation of a long-lived asset do not fall within the scope of FAS 143. Thus, because leaks from fuel storage facilities are inherent in these operations, FAS 143 said these types of remediation liabilities fell within its scope. In contrast, remediation costs associated with a catastrophic accident or spill are not covered by FAS 143. Instead, those costs fall within the scope of SOP 96-1, "Environmental Remediation Liabilities". Also, a past history of lax enforcement by regulatory authorities is not a justification for deferring the recognition of an ARO.

A long-lived asset that has an indeterminate useful life and therefore an indeterminate settlement date also falls within FAS 143. The uncertainty about the timing of the settlement would simply effect the measurement of the liability for that obligation. Since settlement dates are necessary for using present value technique for estimating fair value, the liability would be recognized when sufficient information exists to estimate a potential range of potential settlement dates.

FAS 143 does not apply to obligations of lessees in connection with leased property so long as the obligations meet the definition of minimum lease payments or contingent rentals as set forth in [FAS 13](#). It also does not apply to maintenance obligations or the cost of replacement parts.

After the initial recognition of an ARO liability, FAS 143 provides that the entity should also recognize periodic changes in the ARO from either the passage of time or revisions to the timing and amount of the original estimate. FAS 143 also stated that an

entity will not extinguish its ARO liability by establishing a financial assurance for that ARO (such as an acceptable RCRA financial assurance mechanism for closure or post-closure).

FIN 47

After FAS 143 became effective, it became clear to FASB that many companies and public accounting firms were not consistently applying the standard. A particular problem was the handling “conditional asset retirement obligations” (CAROs) which are defined as a legal obligation to perform an asset retirement activity where the timing or method of settlement are conditioned on some future event that may not be within the control of the entity. Some entities took the position that they could not reasonably estimate the fair value of CAROs because of the numerous uncertainties while others concluded that CAROs were not legal obligations since management could indefinitely defer such obligations—for example, by mothballing or warehousing the assets.

FASB issued FIN 47 to clarify a such key issues as (1) when liability should be recognized for a CARO, (2) when fair value for a CARO may be reasonably estimated and (3) when an entity should be deemed to have sufficient information to reasonably estimate fair value. FIN 47 tightened the reporting standards for environmental liabilities so that entities must reflect future environmental cleanup obligations on their balance sheets even if management has no current plans to retire the contaminated asset

FIN 47 provides that if there is an ARO with an unconditional retirement activity (e.g., closure obligation) but the timing and method of settling the liability may be conditioned on a future event, the entity must recognize a liability for fair value of the conditional ARO if the fair value can be reasonably estimated. FIN 47 states that entities

shall identify CAROs and reaffirms that an assertion of a claim is not a pre-requisite for evaluating and measuring CAROs.

Under FIN 47, the fair value of a CARO may be reasonably estimated if it is reflected in the acquisition price of the asset, an active market exists for the transfer of the asset or sufficient information exists to apply expected present value techniques. FIN 47 states that an entity would have sufficient information to reasonably estimate the fair value if the settlement date and method of settling the obligation has been specified by others such as by law or pursuant to a contract. FIN 47 also clarified that determining a settlement date may sometimes depend on judgments based on specific facts or circumstances such as if a liability may be extended through a contract renewal. However, an entity cannot defer recognition of the ARO where the only uncertainty is whether the performance will be required.

FIN 47 also states that entity will also have sufficient information to reasonably estimate the fair value if there is information to estimate the settlement date or a range of settlement dates, the method or potential methods of settlement and if there is a reasonable basis to assign probabilities to the potential settlement dates or settlement methods. Examples of information that is expected to provide a basis for estimating potential settlement dates includes information from past practice, industry practice, management's intent or the asset's estimated economic life. FIN 47 emphasizes that the narrower the period of time that the entity may settle its obligations and the fewer the methods of settlement has available, the more likely that the company will have sufficient information to reasonable estimate the fair value of the CARO.

FIN 47 contains a number of illustrations that all involve environmental scenarios. One example involves a telecommunications company that uses chemically treated poles. There is no requirement to remove the poles from the ground but the entity may periodically replace them for operational reasons. Once the poles are removed, they must be properly disposed. Interpretation indicated that at the time entity purchased the poles, it had enough information to estimate the potential range of settlement dates, the potential methods of settlement and the probabilities associated with the settlement dates and methods based on industry practices. While the timing of the ARO is conditional on removing and disposing the poles, the existing legal requirements for disposing the poles constitutes an obligating event at the time of purchase. Although the entity may defer settlement by not removing the poles or by reusing them, FIN 47 stated that the ability to defer settlement does not relieve the entity of its obligation since the poles will eventually have to be properly disposed. Selling the poles will also not extinguish the obligation since the sales price will reflect the party's view of the timing and amount of the costs to extinguish the obligation.

The second example illustrates that an ARO may also exist for a component part of a larger system. An entity buys kilns that are lined with special bricks that must be replaced periodically. Because the bricks become contaminated with hazardous substances, they must be properly disposed under RCRA. FIN 47 indicates that the performance of the ARO is conditional on removing the bricks from the kiln and that the existing hazardous waste requirements do impose an unconditional duty to properly dispose the bricks. The ARO is the requirement to dispose of the bricks in an RCRA-licensed facility so the obligating event does not occur until the bricks become

contaminated from use. Therefore, the entity has no obligation at the time of purchase. Once the bricks become contaminated, FIN 47 said that entity would have to recognize the ARO even though there is uncertainty as to when the bricks will actually be removed. However, the cost to replace and install new bricks is not part of the ARO and should be accounted for as a maintenance or replacement activity.

The third example involves a company that acquires a building with asbestos-containing materials (ACM) before the ACM rules for renovation and demolition were adopted. The company has no plans to renovate the plant. Although the timing of the ARO is conditioned on the plan undergoing renovation FIN 47 indicated that an obligating event occurred when the ACM rules were issued. The entity would have to recognize the ARO upon implementation of the ACM rule if it can reasonably estimate the fair value. However, because the time period when the liability may actually be settled is unknown or cannot be estimated (the company has no plans to renovate the plant), FIN 47 said the entity cannot reasonable estimate the fair value of the liability. While the entity does not have to recognize an ARO liability when the ACM regulations become effective, FIN 47 stated that the company should describe the obligation, explain that an ARO liability has not been recognized because the fair value cannot be reasonably estimated and the reasons why it cannot reasonably estimate the fair value.

The final example also involves purchasing a plant with ACM but this time the ACM rules are in effect at the time of the purchase. Here, the obligating event is the acquisition of the plant since the regulations were in effect but because the settlement period is indeterminate, the purchase price does not reflect the fair value. At this point in time, the ARO would not be recognized because the purchaser cannot reasonably

estimate the fair value for the reasons set forth in the third example. Ten years later, though, the plant has to change product lines that will require modifications to the plant. Now, the entity has information to estimate a range of settlement dates, the potential methods of settlement and the associated probabilities. Thus, the entity is now able to estimate the fair value of liability for special handling of the ACM using an expected present value technique.

Practical Implications

Most companies that have large real estate holdings will probably be affected by FIN 47 but its impact depend on how companies have implemented FAS 143. FIN 47 should not significantly impact companies that have broadly interpreted FAS 143 and recognized the fair value of their AROs. However, companies that deferred recognition of their mothballed facilities or own brownfield sites may find themselves obligated to identify CAROs, record or restate these obligations or disclose significant new environmental liabilities.

Earlier this year, FASB issued an Exposure Draft for a proposed new standard for accounting for business combinations. The new accounting standard would replace existing FAS 141 and could significantly impact the way environmental liabilities are recognized and measured in mergers and acquisitions. Perhaps the most significant change will be that the Exposure Draft would require that assets acquired and liabilities assumed in business combinations be measured and recognized at their fair values as of the acquisition date. This the new standard may prove to be the final nail in the FAS 5 coffin for evaluating environmental liabilities.

In August 2005, the SEC also issued a new rule that expanded the events that would trigger the filing of [8-K reports](#). Some of the new triggers could apply to

environmental liabilities. For example, under item 2.05 titled “Costs Associated With Exit or Disposal Activities,” companies disposing of property that required closure would have to issue file an 8-K if the costs would be material. Perhaps more significant is item 2.06 that would require filing of Form 8-K if a company determines a property is material impaired. Entities that are forced to re-evaluate CAROs under FIN 47 may have to file 8-K reports to reflect environmental liabilities that materially impair the fair value of an asset.

FIN 47 must also be viewed in the context of other corporate governing developments, particularly those of the [Public Company Accounting Reform and Investor Protection Act of 2002](#) (“Sarbanes-Oxley” or “SOX”). Under SOX sections 302 and 906, CEOs and CFOs of public companies have been required to certify that their company’s financial statements “fairly present” the financial condition and results of operations of the company. Because of penalties associated with inaccurate certifications, corporate executives have begun to require their firms to conduct more comprehensive environmental assessments to ensure that financial statements are not understating the impact that environmental liabilities may have on company operations. For example, in the past some companies may have estimated closure costs based on assumptions of the extent of soil contamination beneath lagoons and other waste management units. Now, some companies have retaining environmental consultants to conduct extensive soil and groundwater sampling or environmental compliance audits so that the remediation or environmental compliance estimates in financial statements are based on actual data. FIN 47 should only accelerate this trend of more robust environmental diligence.

Corporate executives are not the only ones who need to be concerned about SOX compliance. In 2003, the SEC issued minimum standards of conduct for lawyers under section 307 of SOX that require lawyers to report evidence of a material violation of securities laws or a breach of a fiduciary duty to the chief legal counsel or chief executive officer of the company. If they do not appropriately respond to the evidence, an attorney is required to go “up-the-ladder” and present the evidence of the violation to an audit committee, a committee of independent directors or the full board of directors. As a result, attorneys preparing or participating in the preparation of documents that will be submitted to the SEC will need to consider FIN 47 when reviewing their own obligations under SOX and evaluating if clients’ financial statements “fairly present” its financial condition. Attorneys will also probably have to determine if a “legal obligation” exists that would trigger the requirements of FAS 143 and FIN 47.

SOX section 404 requires reviews and certifications regarding a company’s system of internal control over financial reporting. Recently, the [Public Company Accounting Oversight Board](#) (PCAOB) recently notified companies and auditors that environmental liabilities should be included in the analysis of the adequacy of internal controls. Specifically, PCAOB said that internal controls over financial reporting encompassed controls for “identifying, and measuring environmental liabilities...even if there is no governmental investigation or enforcement proceeding underway”.

It is probably safe to say that most companies probably have not established the kinds of rigorous procedures and controls that would be needed to satisfy the internal control requirements of SOX for identifying, measuring and reporting environmental liabilities associated with properties and facilities owned and operated by the company.

The aggregate impact of these developments suggests that entities will probably have to implement new procedures for identifying and measuring environmental remedial obligations. Indeed, purchasers of assets are beginning to demand representations and warranties in purchase agreements that internal controls are in compliance with SOX

The recent decision of the United States Supreme Court in [Cooper Industries, Inc. v. Aviall Services, Inc.](#) (Aviall)² may exacerbate the impact of FIN 47. Companies that deferred recognizing and remediating historical contamination associated with their facilities may not only find themselves subject to accelerated cleanup obligations but may no longer have the right to seek contribution from prior owners or operators of those facilities for their cleanup costs. Such entities will have to carefully review the post-Aviall decisions in the jurisdictions where the contaminated assets are located to determine if there is a mechanism for preserving their rights of contribution. In some jurisdictions, entering into a settlement agreement with a state environmental agency may be a viable means of preserving contribution rights. In the absence of such a mechanism, entities should carefully assess remedies they may have under state environmental or common law or perhaps rights of indemnity under old contracts.

Companies required to investigate and measure environmental liabilities under FIN 47 will find probably face reporting obligations under state and federal environmental laws and unexpected cleanup obligations that will now have to be recognized on corporate financial statements. It is possible that companies that were previously loath to divest old facilities because of concern over environmental liabilities may not decide that the more prudent course will be to dispose the properties to

² 540 U.S. 1099 (2004).

developers who are willing to assume some or all of the environmental liability rather than having to record remediation costs of non-productive assets on their financial statements. Thus, it is possible that the implementation will result in a flurry of new brownfield redevelopment that would provide economic and environmental benefits to local communities.

Two provisions in particular demonstrate the act's expansion of federal authority. First, the act grants authority to the [Federal Energy Regulatory Commission](#) over the siting of liquefied natural gas (LNG) terminals. The state nonetheless plays an integral role in overseeing operations at the terminal, including the ability to inspect and enforce against violations of environmental and health and safety laws. Second, the act authorizes the U.S. [Department of Energy](#) (DOE) to designate "corridors of national interest" within which the federal government has the exclusive authority to make electricity infrastructure improvements.

Another legislative proposal currently being considered would further expand federal involvement in energy projects. The [Gasoline for America's Security \(GAS\) Act](#), which the House passed in October of 2005, proposes a voluntary program to transfer authority over permitting processes to the federal government in order to encourage the development of refinery capacity. Under the program, states would petition to be included in a federal coordination process for all refinery-related permits at the federal and state level. DOE is tasked with coordinating the approval process for all federal and state permits required to expand or build a new refinery. DOE would establish the schedule for all necessary permits and require all federal and state agencies to process permits within the scheduled deadlines, allowing some permits to be sought concurrently. States that lack the resources to comply with these deadlines may be eligible for federal financial assistance, which could be used to hire additional staff, purchase equipment, or other related resources. The Senate has considered a similar program at the committee level and may introduce additional legislation this year.

It remains to be seen whether and how these provisions will be challenged in litigation and how the courts will resolve the disputes. Even with FERC's newly established federal authority, the permitting process for the Broadwater Energy Project, the proposed LNG terminal located in the Long Island Sound, is ongoing and approval is not certain. Whether consolidation of authority with the federal government will in fact accelerate the approvals process is far from clear. Examples abound of federal approvals for all types of projects that have been delayed for years. And the permitting strategies in the House and Senate refinery bills have a long way to go before they reach the president's desk.

Nonetheless, businesses that have been adversely impacted by permitting delays and insurmountable local opposition may have a reason to be cautiously optimistic that the new act could bring down energy costs. Energy producers and distributors may also benefit from expanded federal authority, although these companies and their attorneys should be mindful of changing requirements that will likely occur as a result of these new provisions. The Energy Policy Act of 2005 may also signal a wider trend toward moving other energy and non-energy related project approval processes to the federal government in order to expedite the construction of projects that are deemed to have national significance.