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Compliance Readiness – Law Firms

New Rules Require Accounting For Future Environmental Costs

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In June 2001, the Financial Accounting Standards Board ("FASB") issued Financial Accounting Standards No. 143 ("FAS 143"), which required that liabilities for existing legal obligations associated with the future retirement of long-lived assets be recognized in financial statements when the asset is acquired or the legal duty is created. FASB used several environmental examples to demonstrate instances in which recognition of costs to comply with legal obligations should not be deferred until the asset was sold or otherwise disposed.

Following adoption of FAS 143, FASB became concerned that FAS 143 was not being applied as intended. In particular, FASB observed that "diverse accounting practices" had developed for recognizing "conditional asset retirement obligations," *i.e*., legal obligations associated with the retirement of an asset that are conditioned on a future event, such as decommissioning or selling a presently operating facility. FASB found that some companies were recognizing the fair value of the retirement obligation, and doing their best to factor uncertainty regarding when and how it would be incurred into the liability's fair value. In contrast, other companies were taking an approach more consistent with recognition of contingent liabilities under Financial Accounting Standards No. 5 ("FAS 5"), *i.e*., recognizing the fair value of the retirement obligation only when it was probable that the asset would be retired on a specific date under specific circumstances.

In March 2005, FASB issued FASB Interpretation No. 47 ("FIN 47") to clarify the manner in which companies should apply FAS 143. FIN 47 states that the fair value of a liability for a conditional asset retirement obligation should be recognized when incurred – generally upon acquisition, construction, or development of the asset. Uncertainty about the timing and/or method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability, rather than serving as a basis for not recognizing or disclosing the liability.

The deadline for implementing FIN 47 has passed – public companies were required to adopt FIN 47 no later than the end of the fiscal year ending after December 15, 2005. From their financial reports, it is apparent that companies are taking different approaches to identifying, estimating, and disclosing conditional asset retirement obligations. Many manufacturers, mining companies, real estate investment entities, financial institutions, and other public companies have announced significant charges to earnings because of FIN 47. Others have said their asset retirement obligations are not estimable or are not material to their operations. This article analyzes some of the vexing questions that companies must face when evaluating the applicability of FAS 143 and FIN 47 to environmental aspects of their operations.

Applying FIN 47 In The Environmental Context

Interpreting and applying FAS 143/FIN 47 for purposes of preparing financial statements, and establishing and testing specific financial controls, are the province of a company's accountants and auditors. It is not our intent here to provide accounting advice. By contrast, it is important that managers and in-house counsel understand, in practical terms, when and how FAS 143/FIN 47 may require that their companies, or one that they may acquire, identify and estimate environmental liabilities. To that end, they should start by asking the four key questions below.

Is There A Current "Legal Obligation" That Is "Associated With Retirement Of A Long-lived Asset?"

Under FAS 143/FIN 47, a "legal obligation" is an obligation that an entity is required to settle as a result of: (i) existing or enacted law, statute, or ordinance; (ii) a written or oral contract; or (iii) promissory estoppel. The legal obligation need not be one that must be carried out immediately for FAS 143/FIN 47 to apply, but it must be binding on the entity. According to FIN 47, neither the ability to defer indefinitely the settlement of an asset retirement obligation, nor the ability to avoid it through sale of the asset, truly relieves a company of the underlying retirement obligation. Therefore, it must be recognized.

FIN 47 uses the example of asbestos in an industrial building to illustrate this point. According to FIN 47, the obligation to remove asbestos cannot be deferred indefinitely because no building lasts forever and existing regulations require asbestos removal prior to demolition. Similarly, the obligation cannot be avoided through sale of the building, as the prospective buyer will either require the seller to remove the asbestos prior to sale or will factor the cost of asbestos management and abatement into the building's purchase price. Therefore, under FIN 47, the cost of asbestos abatement is to be accrued immediately for buildings already owned by a company, or at the time of acquisition for newly acquired assets, using the fair value of such costs.

A similar situation arises for companies operating facilities in U.S. jurisdictions that have transfer acts, such as New Jersey and

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Connecticut, and those outside the U.S. that have decommissioning requirements. In such jurisdictions, a company may have a present legal obligation to investigate, and potentially to remediate, its facilities upon their closure or sale. In jurisdictions without such statutory requirements, however, there may not be a legal obligation to investigate or remediate a decommissioned site, even where a company's past experience at similar facilities indicates that environmental contamination often results from its operations.

As noted above, FIN 47 also applies to obligations assumed by contract, including, for example, the obligation to remove improvements and restore leased premises to their original condition upon termination of a lease. In its Form 8-K filed on January 20, 2006, Citigroup announced a $49 million charge under FIN 47 arising from existing lease termination obligations.

Did The Obligation Result From The "Normal" Operation Of The Asset?

FAS 143 states that it applies to "[a]n environmental remediation liability that results from the *normal operation* of a long-lived asset and that is associated with the retirement of that asset." (emphasis added). In contrast, environmental remediation liability caused by "improper" activities or "catastrophic" events fall outside the scope of FAS 143, and "probably fall … within the scope of SOP 96-1 [concerning estimating contingent liabilities under FAS 5]."

Determining what constitutes contamination arising out of "normal" operations requires an exercise of judgment. Contamination that occurs gradually over time, is not identified with any specific incident or equipment failure, and is commonly encountered as a result of the same or similar operations, generally may be considered "normal." By contrast, contamination that results from improper or prohibited conduct, can be traced to a specific historical event, or would require immediate response action when it occurs may not be considered "normal."

These general distinctions between normal and improper operations are supported by FAS 143's example of "a certain amount of spillage … inherent in the normal operations of a fuel storage facility." This example makes clear that, at least in certain circumstances, spillage incident to use of product storage tanks may be considered "normal operation," and therefore would fall within FAS 143's purview. A similar analysis arguably may apply to dry cleaners, process units at a chemical facility, or pipelines between or within facilities.

At what point contamination moves from "inherent in normal operation" to "caused by improper operation" is open to debate. If contamination is caused by a leak in a pipeline due to age-related wear, for example, and maintenance of the pipeline may have prevented the leak, is the contamination attributable to normal or improper use? The answer may be informed by a company's internal operating procedures, or by externally imposed operation and maintenance obligations. For example, in the context of underground storage tanks, U.S. EPA has promulgated release detection test guidelines specifying that a UST must leak less than 0.1 gallons per hour or 150 gallons per month. Presumably, UST leakage that meets the EPA standard may be considered "normal," while leakage in excess of the standard may be characterized as "improper."

Can The Fair Value Of The Obligation Be Estimated?

FIN 47 states that an asset retirement obligation is reasonably estimable if:

• The fair value of the obligation is embodied in the acquisition price of the asset;

• An active market exists for the transfer of the obligation; or

• Sufficient information exists to apply an expected present value technique.

The first two indicators – deriving value directly from a negotiated acquisition price or indirectly by comparison to rates charged by insurers or others to transfer the risk – are based on market transactions and, as such, are preferred but often unavailable. The third approach, using an expected present value technique, is more likely to apply. Again, whether all variables necessary to quantify an asset retirement liability can be reliably accounted for using an expected present value technique will be a matter of judgment. It is worth emphasizing that, unlike FAS 5, FAS 143/FIN 47 expressly calls for use of this technique. As compared to FAS 5's "probable" and "estimable" standard, the "expected present value" technique encourages quantification of uncertainties and alternative outcomes. By its nature, therefore, it is more likely to result in accelerating recognition of liabilities for which some degree of forecasting is required.

If, after considering all of these factors, a company determines that a fair value determination cannot be made, then the asset retirement obligation cannot be recognized. In that instance, however, FIN 47 requires disclosure in the company's financial statement that the liability has not been recognized because fair value is not reasonably estimable, with an explanation supporting that conclusion.

Is The Obligation Material?

FAS 143 and FIN 47 each states, without further explanation, that it "need not be applied to immaterial items." Therefore, once an estimate of the fair value of an asset retirement obligation has been formulated, a company must determine whether the obligation is "material." Perhaps the key point with respect to the materiality determination is that it should be the *final*, not the initial, step in a company's evaluation of its asset retirement obligations. Even if a company ultimately concludes that its obligations are not material, it should be able to document the internal process for identifying and estimating asset retirement obligations that was followed and led to such conclusion.

Practical Considerations

Given the nature of the questions that must be answered in assessing a company's obligations under FAS 143/FIN 47, such assessment requires a multidisciplinary approach:

• Company operations and environmental personnel must develop an inventory of owned and leased tangible assets, along with their associated environmental conditions (e.g., underground storage tanks).

• Legal counsel must then determine whether there are legal obligations associated with the retirement of those assets, taking into consideration both regulatory and contractual obligations, and evaluate whether those obligations arise from "normal" company operations.

• If a legal obligation does exist, technical environmental experts (internal and/or external) must estimate the costs associated with the obligation. In doing so, they may look to the company's past experience, or to industry practice. Generation of asset-specific cost estimates may require consideration of a number of variables, such as (i) age of the asset relative to expected life of the asset; (ii) size and/or throughput of the asset; and (iii) the location of the asset (which may affect stringency of regulatory requirements, service costs, etc.).

• Finally, accountants must calculate the present fair value of the obligations, incorporating into that calculation any probability analysis associated with the variables identified during the cost estimation process.

FIN 47 makes clear that companies must: (i) periodically review cost estimates and adjust them to reflect changes in expected settlement dates or settlement methods; and (ii) monitor long-lived assets for asset retirement obligations that may arise from a change in regulatory standards or contractual obligations. It also would be advisable for companies to continually evaluate their approach to FAS 143/FIN 47 relative to other companies, to ensure that the approach is not out of step with industry practice. Given the need to continually evaluate their systems for identifying and estimating conditional asset retirement obligations, companies must strike a balance between the complexity inherent in the consideration of asset-specific variables and the need to apply clear and consistent standards across the entire company.