

Estimating and Disclosing the Environmental Costs of Asset Retirement

This Advisory is the third in a series examining the increasing attention being paid to the accuracy and completeness of corporate disclosures pertaining to environmental liabilities. The first, "*The Initiative for Expanded Environmental Disclosure*" (13 May 2003), analyzed the legal climate surrounding environmental cost disclosures, especially in light of the requirements of the Sarbanes-Oxley Act and several emerging trends at the SEC. The second Advisory, "*After Sarbanes-Oxley: Environmental Cost Estimations, Disclosures, and Controls*," (31 March 2005), supplemented the prior publication with special attention to (1) calculating environmental costs, (2) preparing disclosures about those costs, and (3) implementing controls required under Sections 302 and 906 of the Sarbanes-Oxley Act. This Advisory provides further guidance pertaining to the latest developments in this area arising from FASB Statement No. 143 ("Accounting for Asset Retirement Obligations") and its related interpretative guidance, FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" (March 2005) ("FIN 47").

The Costs of Asset Retirement

The disclosure and accounting issues addressed by FAS 143 and FIN 47 arise because companies frequently face future costs associated with retiring various long-lived assets, such as plants and equipment. The textbook example would be nuclear power plant decommissioning, the costs of which could easily approach the asset value of the facility itself.

Most companies face similar environmental obligations associated with asset retirement, which obligations can create substantial costs. For example, a factory may have large amounts of asbestos insulation on boilers, steam pipes, ductwork, and the like. Under normal daily operations, there is no need to remove the asbestos, but if and when the facility were ever decommissioned, there would be an added cost to handle the asbestos in accordance with stringent state and federal regulations. Even if the facility were to be sold without decommissioning, there may be a decrease in the sales price representing the cost (or at least the risk of cost) to the purchaser, or the purchaser may even insist that the asbestos be removed as a condition of the sale. In any event, the fact that the costs are subject to conditions that have not yet arisen does not in any way negate the fact that, at some point, an environmental cost is inherent in the asset itself. To the extent that cost is not reflected in the company's books, the company's assets are relatively overstated.

The difficulty in accounting for these costs arises from three related and unavoidable truths: it may not be clear when (if ever) the cost will be realized; it is usually difficult to project what work will be required to retire the asset; and because of the first two, it is hard to know what that future retirement work will cost. As a result, some companies took the understandable position that such costs could not be projected until such time that the work was certain and capable of reasonable estimation. Other companies developed the less understandable practice of abandoning facilities with substantial retirement costs (known in some circles as "mothballing" the site) so as to avoid any obligation to recognize the environmental costs inherent in decommissioning the facility.

Motivated at least in part by this practice of mothballing environmental liabilities, FASB issued FIN 47. FIN 47 requires a company with any asset retirement liability to recognize the "fair value" of that liability. Such liabilities must be recognized "when incurred," which generally means when the asset is acquired

CONTACTS

If you would like more information, please contact any of the McKenna Long & Aldridge attorneys or public policy advisors with whom you regularly work.

For questions about environmental disclosures, you may also contact:

Edward A. "Skip" Kazmarek
404.527.4160

Or for questions regarding Sabanes-Oxley Compliance generally, contact:

Thomas Wardell
404.527.4990

or when the retirement obligations arise, such as by operation of law. The effective date of FIN 47 was December 31, 2005, although as shown below, companies are just now beginning to understand the full implications of this requirement.

There are a number of subtleties inherent in complying with FIN 47/FAS 143, several of which are discussed below.

Calculating “Fair Value”

As noted in the second Environmental Advisory, estimating future environmental costs is an extraordinarily complicated endeavor even when, as for contingent liabilities governed by FASB 5, the loss is probable. When it comes to future asset obligations, the situation is perhaps even more complicated.

FIN 47 addresses the issue by requiring the company to disclose the “fair value” of its retirement obligations. The fair value is defined as ***the amount for which the asset retirement obligation could be settled in a current transaction between willing parties***. Thus, there are two significant differences between cost estimates made under FIN 47 and those made under FAS 5. First, unlike FAS 5, the “probability” of a loss under FIN 47 affects its value, not whether it is recorded. That is to say, a future obligation that has a chance of being avoided might be traded at a lower cost than one that is certain, but both would have a value. Second, the fair value will carry both a risk premium (which might increase the cost) and a discount factor (which would decrease it). For both reasons, the “fair value” probably will not equal a calculated “expected cost” under other forms of calculations (although, as explained below, the “expected value” may be the starting point for a calculated “fair value”).

One other difference worth noting: FAS 143/FIN 47 generally do not apply to environmental cleanups arising out of “historical operations” (since they are not “retirement obligations”), which are instead covered by FAS 5, although the distinction may not be as tidy as FASB seems to assume. In particular, whether an environmental obligation “exists” is frequently a legally dense and difficult question.

Since fair value is defined as the amount for which the asset retirement obligation could be settled in a current transaction between willing parties, market prices quoted in active markets would obviously be acceptable measures of fair value. Unfortunately, however, such markets generally do not exist for most future environmental obligations. An exception in this regard may be certain kinds of pollution legal liability insurance for which one can insure the cost of a future legal obligation associated with a particular risk. The premium for such insurance would be, in essence, the “fair value” of the future obligation. Because such objective measures do not exist in the overwhelming majority of cases, there has been wide variability in how companies estimate fair value. To minimize this variability, FASB is developing a new statement devoted exclusively to preparing such estimates. The statement is expected to be issued in the near future and has undergone several iterations of discussion drafts.

However the final statement may work out, certain principles are apparent from the various versions of FASB’s draft statement. The FASB draft statement uses a hierarchical approach to the quality of estimates, with the highest preference given to estimates based on direct market evidence or, failing that, indirect market evidence. Only where there is no direct or indirect market input can companies rely on their own input. Significantly, it appears that “undue cost and effort” will not be a sufficient reason for a company to eschew the difficulties of developing a market-based approach and use internal corporate inputs instead. In other words, one might reasonably anticipate that FASB will expect companies to invest considerable time and effort in developing their estimated “fair values.”

Whether a company uses available direct or indirect market data, as opposed to internal company data, is sometimes referred to as the “input” issue. Apart from the source of the inputs to the fair value estimate, though, the tasks against which those inputs are applied can also present substantial difficulty. That is, to calculate a fair value, a company must explicitly incorporate assumptions about the environmental tasks associated with the asset retirement, the timing of work to address those obligations, the cost associated with such work, and reasonable requirements for risk premiums to assume those obligations under current states of knowledge.

One might reasonably sigh at this point, wondering when it is an option to simply abandon the effort and declare that an estimate is simply not possible at the present time. FIN 47 anticipates and addresses that concern.

If the fair value of the obligation is not already known (for example, by a deduction in the purchase price of an asset) and if there is no direct or indirect evidence of the market price for transfer of the obligation, then the fair value must be estimated using other means if “sufficient information” exists to do so. “Sufficient information ” is deemed to exist if either of two conditions exists:

- The settlement date and method of settlement are specified by law, contract, or otherwise; or
- Information is available to reasonably estimate probabilities for both the possible dates of retirement and the potential methods of settlement.

This condition is somewhat reminiscent of the “decision tree” or probabilistic methods associated with estimating the value of contingent liabilities. Since the first condition will rarely exist, it is the second condition where many corporate estimation procedures will roost.

To estimate or not?

FASB and commentators on the emerging standards suggest some possible ways in which the information necessary to conduct these latter forms of estimates may be available: estimated asset lives, industry practices, past experience, and management intent. In fact, however, such inputs may be unknown or too subjective to form a reasonable basis to estimate fair value. In such cases, what should a company do?

Our recommendation in such cases, which is an elaboration of the FIN 47 guidance, is that companies be candid about the liability and disclose its existence and nature, the fact that no fair value has been calculated, why no fair value has been calculated, and whether or not the obligation (individually or in the aggregate) is expected to be material.

Inherent in this option is the limitation that companies not default to fall-back disclosures without a preceding and extensive (and documented) attempt to produce an actual fair value calculation. In other words, in the context of real-world environmental costs, whether it is possible to calculate a fair value is a conclusion, not an assumption, and company processes and documentation should reflect that fact.

In this respect, the processes and documentation for FIN 47 analysis, disclosure, and calculations intersect with the Sarbanes-Oxley requirements for disclosures and appropriate controls, a topic which is beyond the scope of this Advisory. Suffice it to say here, a company with potentially substantial asset retirement obligations, even if unsettled and unaccrued, would do well to carefully consider controls and disclosures surrounding the cost estimations process

FIN 47 itself provides some examples of circumstances that permit calculations of fair value versus those that do not. It is worthwhile to examine a few of these examples:

- When a utility company uses poles treated with various chemicals, it knows that the poles, when removed from the ground, will require special handling at increased cost. It also knows that the poles do not last forever, and indeed can estimate a life cycle for replacement. Costs can be estimated for removal, handling, and disposal. As a result, FASB opines, the asset retirement obligation should be estimated when the poles are purchased. Several other examples follow similar themes.
- Of significance is the example FASB provides of an asbestos-laden factory, where the company cannot estimate the date of retirement, largely because the company would most likely maintain the facility indefinitely through repairs and maintenance. In that case, says FASB, it is not necessary to recognize the fair value of the liability (obviously, since no fair value can be estimated), but FASB does expect the company to disclose: (1) a description of the obligation, (2) the fact that a liability has not been recognized because no fair value can be estimated, and (3) why no fair value can be estimated. We would also suggest that a company disclose whether, in a general sense, the obligation would be expected to be material.

Not mentioned in the FASB examples is one frequently raised by our clients: what about underground storage tanks and other similar assets? Should the company carry the “fair value” of UST removal as a current environmental asset retirement obligation? While our advice generally requires an analysis of several specific company factors, the general rule would seem to be simply an extension of the examples for utility poles and asbestos insulation. If there is a market for future UST removal

obligations, these figures should be used. Failing that, indirect evidence (such as typical reductions in asset sales price) would be appropriate. Finally, if the USTs have useful lives that are known to the company, and the costs of removing and disposing of those tanks can be reasonably quantified (one way or another), then a projected future cost of retiring those tanks can be calculated. With a reasonable basis to apply both a discount rate and a risk premium, the fair value of tank removal can be calculated and should be recorded. On the other hand, if the tanks have an indefinite useful life, or if the dates and methods of settlement are so uncertain that the company simply cannot estimate either when or how the tanks will be removed, then no fair value can be calculated, and the company should simply make a disclosure of that fact and the basis for it along the lines stated above.

Disclosure Experience To Date

As of June 2006, several published reviews indicate several dozen corporations whose disclosure documents expressly recite the adoption of FIN 47 and the amount of a recorded liability. Those disclosures range from a few hundred thousand dollars to several hundreds of millions (!), such as General Motors (\$109 million) and Ford (\$251 million). As one might expect, petroleum and chemical companies also record significant liabilities, including Eastman Kodak (\$57 million) and ConocoPhillips (\$88 million). Energy companies figure prominently in filings to date, with Commonwealth Edison recording \$42 million and FirstEnergy recording \$30 million. In the manufacturing category, Honeywell recorded \$21 million and Goodyear recorded \$11 million. Even some unlikely business sectors are showing up, such as Molson-Coors recording \$3.7 million.

Besides corporate disclosures, two other areas offer some insight into the corporate approach to this emerging issue. First, some companies have actually gone so far as to restate prior releases, such as USA Mobility restating several years' financial statements to indicate millions of dollars in current liabilities and asset retirement obligations. Second, there have been nearly a dozen disclosures of "material control deficiencies" in connection with FIN 47 or related analyses, such as the very telling admission by Petroleum Development Corporation that, "The Company did not have effective policies and procedures, or personnel with sufficient technical expertise, to ensure that its accounting for asset retirement obligations complied with generally accepted accounting principles."

As noted above, the effective date for FIN 47 was last December 31. Judging by the pace of disclosures such as these, however, companies are still struggling to bring their cost estimation and disclosure practices into line with current requirements.

Conclusion

FIN 47 is generally regarded as having substantial and far-reaching implications and, as shown above, has created a flurry of activity as companies strain to come to grips with the requirements. The real effects of FIN 47 are probably both more and less substantial than commonly perceived. In some ways, the requirements of FIN 47 are not as dramatic as they appear (although, admittedly, that statement sounds a lot like "Wagner's music is not as bad as it sounds"). First, many companies have already recognized future environmental costs associated with asset retirement as a contingent liability under FAS 5. For example, many of our clients with permitted hazardous waste operations have been carrying future investigation and cleanup costs for some time. Second, in a number of instances, the retirement obligations are completely hypothetical and no fair value estimation is even remotely possible. In such cases, all that is required is an appropriate disclosure, which many companies have already made or could easily incorporate into current disclosures.

However, having said that, one should not underestimate either the importance of what FASB is trying to compel through FIN 47 or the dramatic change in accounting and disclosures that some companies will be forced to make. It is an undeniable fact that many companies have future environmental obligations that are nowhere quantified or even disclosed. This silence presents a distorted and potentially misleading picture of the company's balance sheet and FASB is encouraging, actually demanding, that companies rectify the misstatement and provide investors with an accurate picture of the company's financial health.

For further information, contact any of the persons indicated above.

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