Compliance Readiness – Law Firms

SEC Enforcement Action Shines Light On Environmental Disclosures

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A recent enforcement action by the SEC suggests that the SEC may be giving new attention to environmental disclosures. This action should serve as a wake-up call to companies to review accounting policies to ensure compliance with new accounting standards, including in particular the Financial Accounting Standards Board's new Financial Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* ("FIN 47").

In Re Ashland Inc.

On November 29, 2006, the SEC issued a "cease and desist" settlement order to Ashland Inc. and its former Director of Environmental Remediation, William Olasin. *See In re Ashland Inc. and William C. Olasin*, Administrative Proceeding File No. 3-12487 (November 29, 2006).

Ashland Inc. is a Fortune 500 chemical company incorporated in Kentucky. The company is responsible for remediating environmental contamination at dozens of sites around the country, and Ashland's environmental reserve is thus a significant item in its financial statements. In the settlement order, SEC accused Ashland of materially understating its environmental reserve and overstating its net income by reducing cost estimates for environmental remediation. The settlement order states that Ashland violated the reporting, books and internal controls provisions of the Exchange Act because its internal controls were inadequate to prevent these violations from occurring.

SEC Has Also Raised Questions About Companies' Compliance With FIN 47

The *Ashland* settlement demonstrates the need for companies to review their internal controls to ensure proper accounting for environmental liabilities. Consistent with its interest in environmental disclosures in the *Ashland* case, the SEC has issued numerous staff review letters questioning companies' compliance with FIN 47.

Readers of this publication should already be familiar with FIN 47 because public companies were required to adopt this standard for fiscal years ending in 2006. (Also, *The Metropolitan Corporate Counsel* reported on this new requirement in its April 2006 issue). Nonetheless, the response to this new standard has been extremely variable, suggesting

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that many companies may need to review and update their internal controls to avoid *Ashland*-style problems in the near future. Already, several other companies have discovered and reported "control deficiencies" related to FIN 47 compliance in their annual or interim financial statements.

Compliance with FIN 47 has varied. In March 2006, the Controller's Leadership Roundtable published an executive briefing entitled *The Impact of FIN 47 (So Far)*. The initial "key takeway" was that companies are reporting a widely varying impact from the implementation of FIN 47. This is true even among companies within the same sector of the economy. For example, United Technologies reported a $95 million impact from the implementation of FIN 47 while Caterpillar, Inc., a company in the same sector, listed FIN 47's impact as "immaterial." It is perhaps not a coincidence that the Roundtable also found that companies' efforts to comply with FIN 47 varied just as widely – with survey answers ranging from 5,000 hours to just six.

For most companies, a good-faith effort to comply with FIN 47 will require a substantial investment of time – much more than six hours – to conduct a thorough review of existing assets and legal obligations to determine the types of asset retirement obligations that must be disclosed and to develop consistent, defensible policies for determining when the fair value of such obligations can be reasonably estimated. A brief overview of the new standard is provided below to provide a sense of the effort that will be required.

Determining whether an asset retirement obligation must be disclosed. FIN 47 interprets the Financial Accounting Standard (FAS) No. 143, *Accounting for Asset Retirement Obligations*, which was issued in 2001. An asset retirement obligation (ARO) is a liability associated with the permanent removal of a long-term asset from service, and a "conditional ARO" is an ARO for which the timing or method of settlement is conditional upon a future event that may or may not be within the company's control. Accounting practices for such liabilities generated substantial confusion prior to FIN 47. Although many companies would account for the fair value of the obligation prior to the retirement of the asset, with any uncertainty about the timing or method of settlement incorporated into the liability's fair value, many other companies would defer recognition of the liability until the asset was actually retired. Provided a fair value for the liability can be reasonably estimated, FIN 47 clarified that such liabilities must be recognized "when incurred" – generally upon acquisition, construction or development or through the normal operation of the asset.

FIN 47 applies whenever "an existing law, regulation or contract requires an entity to perform an asset retirement activity, even if that obligation can be deferred indefinitely." This is substantially different from the historical way of accounting for such liabilities. Therefore, the first step in FIN 47 compliance should be to develop an inventory of the types of asset retirement obligations that might need to be recognized based on both legal and contractual requirements.

The best example of an existing legal obligation that can be deferred indefinitely is asbestos. Asbestos-containing materials are ubiquitous in older structures throughout the United States. In most cases such materials can be managed in place at limited expense without removing the asbestos. When a facility is demolished or renovated, however, existing laws may require such materials to be removed and disposed in a special manner. Therefore, FIN 47 requires the entity to recognize the liability associated with asbestos removal immediately, provided the fair value of this obligation can be reasonably estimated.

FIN 47 also states that "uncertainty about whether performance will be required does not defer recognition of an asset retirement obligation because a legal obligation to stand ready to perform still exists." This could put many companies in a very uncomfortable situation. Take, for example, the common lease provision requiring property to be returned in as good condition as when the lease was executed. For many companies such provisions could require substantial expenditures for environmental remediation and related activities. Because the requirement is an "existing legal obligation" under the lease, FIN 47 may impose an obligation on companies to disclose the liability. FIN 47 may require disclosure in some cases where the AICPA accounting standard for Environmental Remediation Liabilities (Statement of Position 96-1) would not. If so, this may be an instance where the company's fidelity to the new accounting standard could undermine its bargaining and/or litigation position. Clear, defensible policies must be established at the company level to determine how to resolve such conflicts.

FIN 47 compliance will also require a continuing awareness of new legal and regulatory developments, as is illustrated by the evolving regulation of "electronic wastes." Because computers and monitors and related equipment may contain a wide variety of hazardous substances, such wastes are increasingly subject to regulation. The European Union, for example, recently issued a Directive on Waste from Electrical and Electronic Equipment ("WEEE"), which took effect on July 1, 2006. Among other provisions, WEEE obligates commercial users to incur costs associated with the retirement of electronic assets. In response to WEEE, the FASB has issued a statement (FSP FAS 143-1) indicating that WEEE creates an asset retirement obligation that must be recognized by entities subject to the EU Directive "when incurred" – generally, when the electronic assets are acquired – in accordance with FIN 47. As domestic government entities consider the adoption of regulations similar to WEEE, companies must be prepared to determine whether they any new domestic regulations create additional "existing legal obligations" that will need to be recognized as AROs.

Determining whether a liability can be reasonable estimated. Once it is determined whether an ARO must be disclosed, the next question is whether a "fair value" for that obligation can reasonably be estimated. FIN 47 requires the use of the expected value technique to measure fair value. This method accounts for any uncertainty about the amount and timing of future cash flows. FIN 47 also clarifies that an entity has sufficient information to assign a fair value to the ARO based on the expected value technique in the following situations (1) when the settlement date and method of settlement for the obligation have been specified by law, regulation or contract; or (2) when the company has sufficient information to estimate the range of potential settlement dates, the potential methods of settlement, and the associated probabilities. Such information might be derived from the company's past practice, industry practice, management intent or the asset's expected economic life.

If sufficient information is not available at the time the obligation is incurred, FIN 47 still requires the company to disclose that fact along with an explanation of its rationale. In the asbestos example above, it might not be possible to estimate the fair value of the asbestos removal obligation if the entity has no plans to demolish or renovate the facility. If that is the case, the entity must disclose (1) a description of the liability; (2) the fact that a liability cannot be recognized because the fair value cannot be reasonably estimated; and (3) the reasons why a fair value cannot be estimated.

Further, the company will be required to recognize a liability as soon as it becomes possible to recognize a fair value for the liability. In the asbestos example above, for example, the company would be required to estimate a liability as soon as information becomes available to allow it to estimate when the facility will need to be renovated or demolished. Therefore a recognition by management that renovations will be required to respond to changes in demand might trigger that requirement. Companies must develop internal controls sufficient to ensure that the accounting significance of such developments is recognized and reported.

Conclusion

In sum, the SEC's recent enforcement action in *Ashland, Inc*. is a reminder that environmental disclosures, including but not limited to the disclosures required by FIN 47, cannot be ignored. Most companies would be well-advised to review existing procedures and controls to ensure compliance. It is essential that the standards used to determine whether and how to report environmental liabilities be defensible, well-documented, and consistent with Sarbanes-Oxley reporting and certification requirements.

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