CORPORATE ENVIRONMENTAL DISCLOSURE COLUMN

Reconsidering Loss Contingency Postponement—Raising the Game

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INTRODUCTION

Companies have had the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5 (FAS 5), *Accounting for Contingencies*, to apply since 1975 in deciding what, if any, loss contingencies,[2] including environmental loss contingencies,[3] to recognize and disclose as liabilities.[4] Under FAS 5, companies have been able to postpone recognition and disclosure of loss contingencies if they are *uncertain* about liability costs, i.e., if they find costs are not reasonably estimable. *Postponement* means liabilities are kept off company books and out of financial statements in the *near term*, which understandably has appeal. Might companies be better served in the *long term*, however, by avoiding postponement?

Here's the problem. Companies postponing recognition of loss contingency liabilities likely also are postponing management of them, including cost management. This means favorable cost situations that may develop for resolving those liabilities will be missed. It means that dates for their resolution and removal from company books and financial statements following their eventual recognition are being pushed further into the future.

More problematically, it means liability costs that are increasing with time are raising a company's liability exposure. Costs for environmental cleanup are particularly susceptible to increase. It may be from cleanup

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[2] A loss contingency is: An existing condition, situation, or set of circumstances involving uncertainty as to possible…loss (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur (FASB, 1975)

[3] Environmental loss contingencies typically faced by many companies are environmental cleanup and litigation.

[4] FASB defines liabilities as: Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide other services to other entities in the future as a result of past transactions or events. (FASB, 1985)

requirements of regulatory authorities that become more stringent and thereby more costly to meet, for example. There may be structural deterioration from weathering that makes cleanup more costly to conduct. Additional cleanup may be necessary where contamination sources have been insufficiently secured, e.g., against human and animal intrusion, wind transport, surface water erosion and infiltration. There may be more exposure of personnel to contaminated materials or more subsurface migration of contaminants as time passes. Companies inclined to postpone recognition (and management) in the near term—from uncertainty about costs—may find themselves with higher environmental liability costs over the long term.

FAS 141R, *Business Combinations (Revised)*, a new standard effective in 2009, takes a different approach than FAS 5 to uncertainty about loss contingency liability costs. As amended by FSP FAS 141R-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies* on April 2, 2009, it requires companies to recognize a liability cost (at acquisition-date fair value) "if [it] can be determined" (FASB, 2009). That is, companies are expected to make the effort to estimate cost, despite cost uncertainty. In general, it is normal for companies to be able to determine costs for environmental cleanup contingencies by using expected value methodology, in which uncertainty about cost is incorporated (as probability) into cost estimation.

FAS 141R directly applies only in particular situations, i.e., in determining loss contingency liabilities for acquired properties in business combinations (e.g., in mergers and acquisitions). Meanwhile, FAS 5 continues to be broadly applicable, as before.

It may be useful for companies implementing FAS 5 to consider FAS 141R's role for uncertainty in cost estimation. That is, it may be smart for companies to look again at postponement of recognition of loss contingency liabilities from uncertainty about liability costs. Is postponement contributing to good financial management? What about vulnerability to cost increases? Is there opportunity to improve management of liability costs, i.e., to "raise the game?" Might this include shifting emphasis in FAS 5 implementation from minimization of liability recognition in the near-term to minimizing liability costs over the long term? What is appropriate under FAS 5? How might it proceed? What might be the outcome?

WHAT CONSTITUTES THE OPPORTUNITY TO POSTPONE UNDER FAS 5?

FAS 5 requires that a company recognize and disclose a loss contingency as a liability if it is *probable* that a liability has been incurred and the amount of loss, i.e., the liability cost, can be *reasonably estimated*. Both criteria must be met before recognition (and disclosure) is necessary.

A company may determine that incurrence of a liability is probable, but that it cannot reasonably estimate the liability cost, i.e., that it is too uncertain about cost. In which case, the company may postpone recognition of the liability (until liability cost can be estimated).

It is, in general, defensible when companies reach conclusions that liability costs are not reasonably estimable, for several reasons. First, being uncertain about cost is not an unlikely development. Where there is not an active market indicating cost for an identical item, an effort to estimate cost likely needs consideration of factors about which uncertainty exists. A company may feel it unnecessary or be otherwise unwilling or unable to allocate the resources to resolve uncertainty sufficiently for an estimate.

Second, FAS 5 enables a company's subjective judgment about what is reasonably estimable. FAS 5 does not define reasonable estimability. Its guidance is this, that the criterion of reasonably estimable:

> …is intended to prevent accrual in the financial statements of amounts so uncertain as to impair the integrity of those statements. (FAS, 1975)

This addresses unhelpful estimation, but it does not indicate characteristics of reasonable estimability.

Third, FAS 5 makes it a company's choice how it goes about cost estimation. FAS 5 gives no instructions about measurement approach. A company may choose an estimation approach that does not enable it to consider or otherwise overcome cost uncertainty.

Companies have FASB Interpretation No. 14 (FIN 14), *Reasonable Estimation of the Amount of a Loss*, for additional information about determining when a cost is reasonably estimable. Under FIN 14, when a company can discern a range of loss, i.e., when it can identify low and high values, then it must conclude it can reasonably estimate the cost of the loss contingency. This means, according to FIN 14 instructions, that a company should not delay recognition (and disclosure) until it has a single, best cost estimate. Having a cost range is sufficient evidence of a cost being reasonably estimable. A company still retains the opportunity to delay recognition under FIN 14 by finding it cannot determine a range, e.g., that a high value cannot be estimated yet.

FASB also has indicated in FIN 14 that if one amount in a range is a better estimate than others, then that most likely value should be recognized. When no amount (in a range) is a better estimate, then the low value is to be used, i.e., the known minimum value. Recognition of the low value in a range should not necessarily be considered good handling of uncertainty in cost estimation, however.

Here is the question that remains. While it may be defensible—using the opportunity available under FAS 5 to postpone liability recognition (or to recognize the known minimum value)—is it compatible over the long term with sensible liability and financial management, i.e., is it sensible?

HOW IS FAS 141R'S APPROACH TO UNCERTAINTY DIFFERENT?

Under FAS 141R, effective beginning in 2009, companies have instructions about how to measure loss contingency liability costs.[5] In particular, through reference to FAS 157, *Fair Value Measurements*, it recognizes that active markets will not be available to establish values for some liabilities. This includes environmental cleanup liabilities.[6] Costs for those liabilities may be determined using an expected value approach, which takes cost uncertainty into consideration.

This new standard, FAS 141R, directly applies only to a subset of companies, to the surviving entity in business combinations (e.g., mergers and acquisitions). As well, it pertains only to acquired properties, not to all the entity's properties.

FAS 141R's approach to cost estimation for environmental cleanup-type liabilities, i.e., using expected value, applies conceptually, however, to loss contingency recognition under FAS 5. The expected value approach includes expected cash flow and expected present value. Expected present value incorporates consideration of the time value of money, unlike expected cash flow. Their application is sketched briefly below.

HOW CAN EXPECTED CASH FLOW BE HELPFUL?

The expected cash flow approach incorporates uncertainty about costs into cost estimation. This means cost estimation can proceed instead of being defeated by cost uncertainty.

ASTM E2137-06, *Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters*, gives this definition for expected value:

> …An estimate of the mean value of an unknown quantity that represents a probability-weighted average over the range of all possible values. (ASTM, 2006)

That is, an expected value (an estimated cost) incorporates consideration of cost uncertainty by being a probability-weighted average of expected cash flows.

For situations in which there is no market for obtaining a quoted price, e.g., the normal circumstance for environmental cleanup liabilities, ASTM E2137-06 ranks the expected value approach higher in robustness and comprehensiveness than other familiar measurement options. Those other options, in decreasing rank, are most likely value, cost range, and known minimum value.

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[5] FAS 141R requires that liability costs for loss contingencies be measured at acquisition-date fair value, if it can be determined, and references FAS 157 for details in methodology.

[6] FAS 157 establishes a three-level hierarchy of measurement inputs to facilitate consistency and comparability in measurement results. At the third level is cost measurement with significant unobservable inputs, i.e., not derived from observed market transactions. Much of cost estimation for environmental cleanup is at this level.

FAS 143, *Asset Retirement Obligations*, in Appendix C, shows application of the expected cash flow approach, which is useful here for a succinct portrayal of the approach. The Appendix C example is for retiring (i.e., dismantling and removing) an offshore oil platform. Three cash flow estimates are given: \$100,000, \$125,000, and \$175,000. Probabilities (of being the outcome value) are assessed, respectively: 25%, 50%, and 25%. The individual expected cash flows are (the products of the cash flow estimates and the probability values), respectively: \$25,000, \$62,500, and \$43,750. The overall expected cash flow is \$131,250, the sum of the probability-weighted, individual cash flows. (FASB, 2001) This demonstrates the incorporation of uncertainty about cost (as probability) in cost estimation.

WHEN CAN EXPECTED PRESENT VALUE BE USEFUL?

What the expected present value approach adds to the picture is consideration of the time value of money. This is useful when resolution of a liability is anticipated at a future date—the further into the future, the more valuable its consideration. Through discounting, the expected present value approach enables recognition of a reduced estimated cost (discounted relative to its matured value). This value is accreted (increased) until it reaches its mature liability value when the liability is scheduled for resolution. Distinctive in this expected value approach is the opportunity for a company to postpone recognition (and disclosure) of the full liability cost until resolution of the liability is expected, with systematically-determined lesser amounts, progressively increasing, being recognized until that time.

For demonstration, again, here's example information from Appendix C of FAS 143. A liability having a matured value of \$440,619 is recognized in year one at an estimated cost of \$194,879, in year two at \$211,444, and so on, increasing to \$440,619 in year 10, based on a (credit-adjusted, risk-free) discount rate of 8.5%. (FASB, 2001) This demonstrates the potential usefulness to a company of including consideration of the time value of money, i.e., discounting, in cost estimation for liabilities having resolution dates that are not imminent.

AN ADDITIONAL CONSIDERATION

Companies implementing FAS 141R may be creating for themselves a second class of loss contingencies, or perhaps a second class of loss contingency properties. This will result if their cost estimation for loss contingencies under FAS 5 remains different than under FAS 141R. That is, if there is no adjustment in how cost estimation under FAS 5 is performed, then companies will be recognizing more loss contingencies and at higher estimated costs for acquired properties (under FAS 141R) than for comparable, older properties (under FAS 5), i.e., those not part of acquisitions in 2009 (or thereafter). This is, in part, because the expected value approach to cost estimation required under FAS 141R enables costs to be determined, despite cost uncertainty, and at more credible (higher) values than the low number from cost ranges.

Loss contingency liability management will be made more complicated for those companies applying different cost estimation approaches under the two standards, FAS 141R and FAS 5. They will find it difficult to compare liability values among loss contingencies (e.g., for decision-making about resource allocation) when differences in those liability values are due to both the nature of the loss contingencies and the cost estimation approach applied.

HOW MIGHT A COMPANY RAISE ITS GAME?

Companies may determine that incurrence of a loss contingency liability is probable, but fail to recognize the liability because of uncertainty about liability costs. This likely means management, including cost management, will not proceed for those unrecognized liabilities. The company, as a result, will miss the development of favorable cost situations for resolving those liabilities, should they arise. It is postponing indefinitely the resolution and removal from company books of those yet-to-be recognized liabilities. To the extent that liability costs increase with time, as reasonably may be anticipated for environmental cleanup liabilities, a company's liability exposure is growing. That is, it will be subject to higher liability costs over the long term.

Cost estimation is an initial step in systematically managing liability costs. It means liability costs subsequently can be refined, tracked, evaluated, and, with application of appropriate techniques, minimized over time.

Liabilities on the balance sheet receive attention for resolution. It puts them on course for resolution. With timely recognition and disclosure, companies avoid the perception by shareholders and investors of late disclosure, which can undermine other evidence of good management

Intending to minimize liability recognition in the near term understandably has appeal. It has its place in a company's consideration of what is involved in good financial management and its review of priorities. Placing greater emphasis, however, on minimizing liability costs over the long term may be seen as more sensible and part of raising a company's liability and financial management game.

CONCLUSIONS

Postponing loss contingency liability recognition is defensible. Whether a liability cost is reasonably estimable is a company's subjective judgment under FAS 5. As well, the approach a company takes in cost estimation is its own choice under FAS 5. Under FIN 14, when a company can discern a range of loss, it must conclude it can reasonably estimate cost. Its opportunity under FIN 14 to recognize the low value of the range, i.e., the known minimum value, when a better value is not apparent should not be considered adequate handling of uncertainty in cost estimation, however.

Proceeding with loss contingency liability recognition warrants consideration for the potential opportunity to be more sensible in liability and financial management. Approaches for estimating liability cost, despite cost uncertainty, are available and demonstrated in contemporary standards. The advantage in recognition is that costs, once estimated, can be refined, monitored, and managed. These are part of minimizing liability costs over the long term.

In particular, a company may "raise its game" by shifting emphasis in its FAS 5 implementation from minimizing liability recognition in the near-term to minimizing liability costs over the long term. The necessity for a subset of companies to begin implementing FAS 141R in 2009 may be timely reminder to others that cost estimation for environmental cleanup loss contingency liabilities can proceed, and perhaps should, despite cost uncertainty.

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