TAEP Luncheon

Environmental Liability Estimates for Financial Reporting

Joy M. Young
May 18, 2017

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About Us

Oak Advising & Consulting, Inc.

Oak Advising & Consulting, Inc. is a specialty firm focusing on helping our clients meet their operational and financial challenges in the areas of EH&S risk and management; corporate finance; enterprise risk management; and financial restructuring. Our members bring to their clients the knowledge and experience gained from long positions in public accounting and industrial corporate leadership. Additionally, we support public accounting firms in their audit duties by offering deep external Environmental Specialist support and can leverage our unique experiences to partner with other consultancies to bring value to their clients.

Joy Young

Through her academic education as an environmental toxicologist, and her professional experiences in engineering and "Big 4" accounting firms, Ms. Young is an accomplished environmental risk practitioner who works across a broad range of sectors to help clients identify and mitigate financial risk from environmental, health and safety issues. Ms. Young is also a member of the ASTM task group working to develop a new standard for Recognition and De-recognition of Environmental Liabilities.

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Key Take-aways

"Bad News"

- You (as the external remediation estimator) may be subject to significant risks which may not have been previously considered.
- Risks and costs of business could be increased by recent developments from the SEC and PCAOB.

"Good News"

- Mitigating most these risks is fairly straightforward and many are free;
    1. Become generally familiar with the processes and rules, and then....
    2. Communicate! Communicate! Communicate!
        - External auditors
        - Internal accounting
        - Internal legal
        - Internal real estate
        - Internal tax
        - External engineering provider

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Overview

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Topics

1. The Processes

2. The Rules

3. The Most Common Pitfalls

The Challenges

What's New

- PCAOB Requirements
- SEC Letters
- Leadership/political changes
- New ASTM standards

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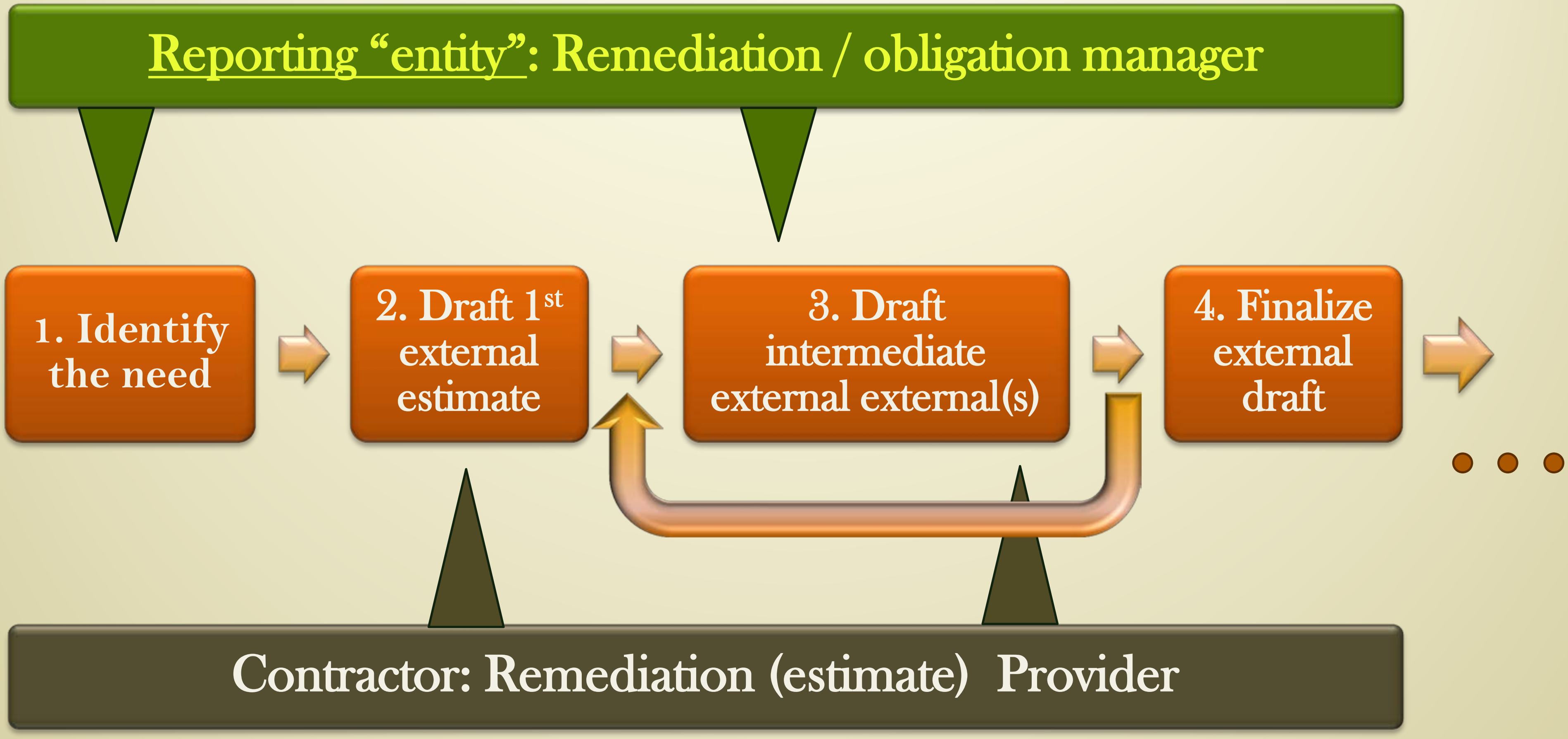
The Processes

Typical Remediation Estimate Development



In the initial steps:

- **Is the need fully identified? Are all necessary areas of the obligation accommodated?**
- **Is the need fully communicated? Does the contractor understand the PURPOSE, scope, framework, and limitations of the requested estimate?**

Uses of the Remediation Estimate

Remediation / obligation Manager, Legal, Management, etc.

4 . Finalize external draft

5. Entity edits estimate?

A. Budget/spending

Lowest possible estimate?

B. Due diligence

Risk-based estimate?; Include operational risks or costs?

C. Financial reporting

Subject to highly specific rules

D. Regulatory reports/response (ex. financial assurance, FS)

Subject to specific rules;

Omit certain costs?

E. Insurance / PRP recoveries

F. Settlements / contracts

G. Misc. / other

Subject to terms, conditions, agreements, limitations, etc.?

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Estimates that start off with a different initial purpose may be fed subsequently into into the financial statements

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Subsequent Processes Involving the Estimate

A. Typical budget/spending track

6A. Compare to budget

7A. "Shop" estimate? Request lower cost estimate?

E

C

8A. Submit to Purchasing dept; draft purchase order

9A. Draft, sign, and execute a contract

B. Due diligence track

6B. Compare to transactional and/or risk value

7B. Execute acquisition or dispersal of property/ asset/ business

8B-1. Settle the liability (wholly or partially) with purchaser

OR

8B-2. Assume the liability (wholly or partially) from seller

C. Typical financial reporting track

6C. Submit to financial reporting department

7C. Estimated modified / edited by Acctg. Department?

8C. Acctg. Department prepares financial statements (*)

9C. Financial statement information submitted to public accounting for external audit

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* Annual, quarterly, or special event

“Sidebar” : A Few Impacts of Sarbanes-Oxley (“SOX”), 2002

- Created the Public Company Accounting Oversight Board (PCAOB)
- Establishes standards for external auditor independence
- Requires that signing officer(s) must attest to the validity of all reported information and that responsibility for validity is individual. Imposes potential criminal penalties.
- Requires that company’s establish, maintain, and monitor the effectiveness of internal controls.

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Subsequent Processes Involving the Estimate

C. Typical financial reporting track

Entity: Financial reporting professionals (accountants)

- 6C. Submit to financial reporting department
- 7C. Estimated modified / edited by Acctg. Department?
- 8C. Acctg. Department incorporates into financial statements
- 9C. Financial statement information submitted to public accounting for external audit
- 10C. Estimate account considered for audit procedures
- 11C. Individual estimates selected as population samples* by the auditor for further procedures
- 12C. Auditor applies procedures including substantive testing to individual estimates
- 13C. Auditor concludes on the reasonableness of management's estimate based on the procedures

Auditor: External, public accountants and their SMEs (aka "Specialists")

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* Statistical or non-statistical

Subsequent Processes Involving the Estimate

C. Typical financial reporting track

14C. Estimate edited based on conclusion of the auditors ?

15C. Estimate included in final financial statements (may or may not be publicly published); auditor issues opinion

16C. Audit could be selected for PCAOB review (public), audit work, including estimate assessment is reviewed by the regulator

17C. Based upon PCAOB inquiries, estimate may be subject to further procedures

18C. Estimate may be revised; financial reporting may be revised

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Financial Reporting: New Potential Auditing Requirements

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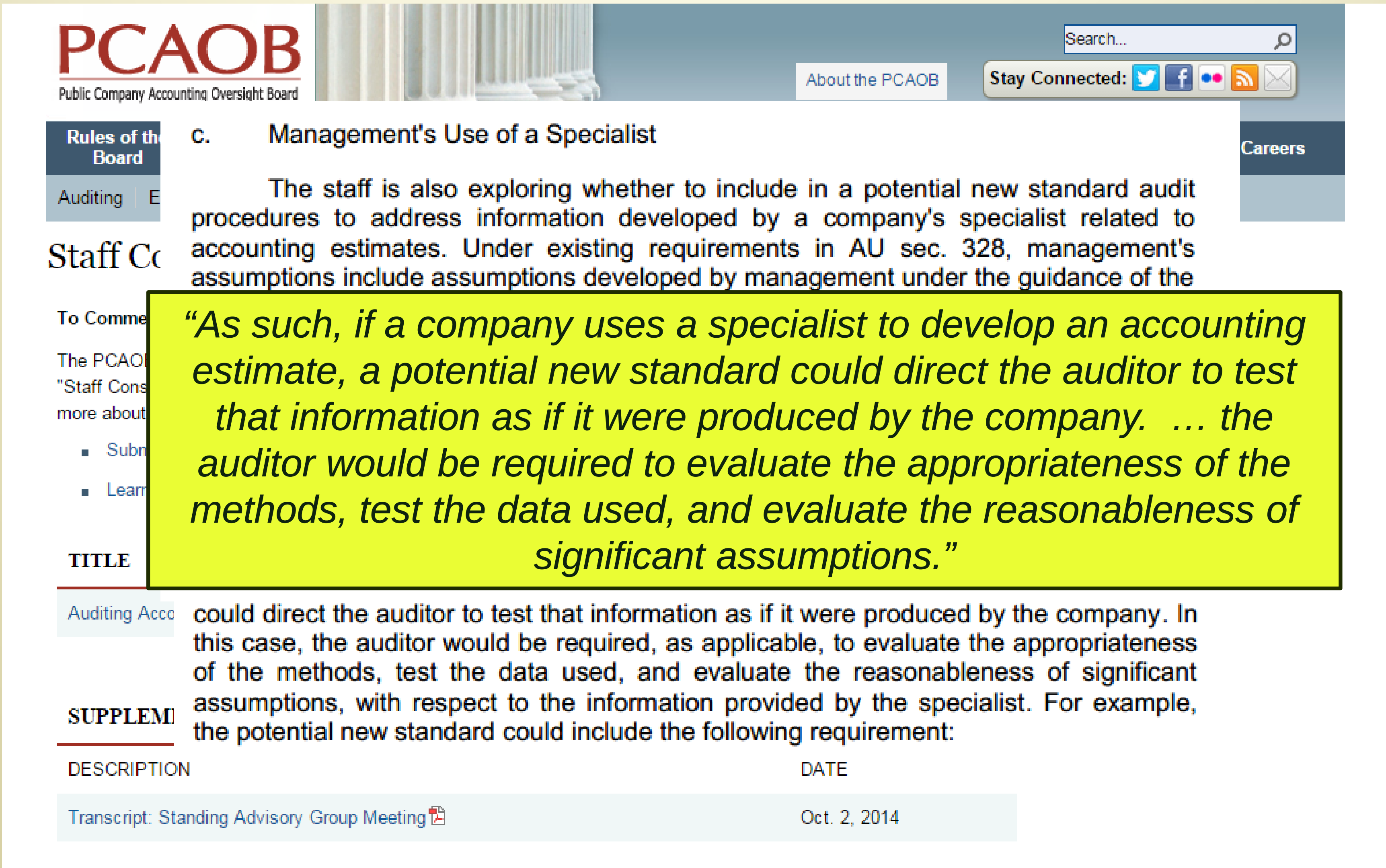

"As such, if a company uses a specialist to develop an accounting estimate, a potential new standard could direct the auditor to test that information as if it were produced by the company. … the auditor would be required to evaluate the appropriateness of the methods, test the data used, and evaluate the reasonableness of significant assumptions."

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The Rules

Financial Reporting: Basic Concepts

- Financial Reporting includes:
  - Financial Statements
    - Income Statement, Statement of Cash Flows
      - includes information on expenses incurred in the reporting period
    - Balance Sheet
      - Accruals (reserves) for environmental liabilities and asset retirement obligations (among others)
  - Notes to Financial Statements
    - Text-based discussion of entries in the financial statements and other comments
  - Disclosures
    - Among other things, should consider including discussion of cost risks including
      - Un-asserted legal claims/litigation
      - Enforcement cases pending disposition
      - Inestimable or reasonably possible remediation liabilities

Financial Reporting: Basic Concepts

- Accounting information used for financial reporting should be:
  - **Relevant** - the information provided has predictive value, feedback value, and is timely
  - **Reliable** - the information is faithfully represented, neutral, and verifiable
- Accomplished through accounting standards:
  - include the standards, conventions, and rules that accountants follow in recording and summarizing and in the preparation of financial statements designed to standardize such reporting → allows comparative assessments of financial statements
  - **US GAAP:** "Generally Accepted Accounting Principles" adopted by the U.S. Securities and Exchange Commission (SEC) and codified by the Financial Accounting Standards Board (FASB) in the Accounting Standards Codification (ASC). For governmental agencies, includes principles from the Government Accounting Standards Board (GASB).
  - **IFRS:** "International Financial Reporting Standards" developed by the International Accounting Standards Board (IASB); used extensively internationally.
  - **Others**

Under which standards does your (or your client's) organization report?

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Financial Reporting: Accounting Standards Related to Env. Liabilities

- **US GAAP: US Generally Accepted Accounting Principles --** Outlined in the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC)
  - ASC 450-20: Accounting for Contingencies, Loss Contingencies (formerly, FASB Statement No. 5, "FAS 5");
  - ASC 410-30: Accounting for Environmental Remediation Liabilities (formerly, Statement of Position (SOP) No. 96-1);
  - ASC 410-20: Accounting for Asset Retirement Obligations (formerly, FASB Statement No. 143 ("FAS 143") and FASB Interpretation No. 47 ("FIN 47");
  - ASC 820: Fair Value Measurements (formerly, FASB Statement No. 157);
  - ASC 805: Business Combinations (formerly, FASN Statement 141(R));
  - SEC Regulation S-K, Section 229.103 (disclosures of material pending legal proceedings)
  - GASB 83: Governmental Accounting Standards Series, Statement No. 83, Certain Asset Retirement Obligations
  - GASB 49: Governmental Accounting Standards Series, Statement No. 49, Accounting and Financial Reporting for Pollution Remediation Obligations
- **International:**
  - IFRS: International Accounting Standard (IAS) 37 "Provisions, Contingent Liabilities, and Contingent Assets"

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Financial Reporting Concepts : Definitions

•Key definitions under U.S. generally accepted accounting standards (GAAP). Note that IFRS has similar concepts though, definitions may vary slightly.

– Liabilities: **probable [1] future sacrifices** of economic benefit **arising from present obligations** of a particular entity to transfer assets or provide services to other entities in the future **as a result of past transactions or events.**

– Contingency: an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.

– Contingent liability: a loss contingency giving rise to the probable incurrence of a liability.

1 – for purposes of this definition, "probable" is used with its usual meaning, rather than in a specific accounting or technical sense. I.e., that which can reasonably be expected or believed on the basis of available evidence or logic, but is neither certain nor proven.

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Financial Reporting Concepts: Recognition under GAAP

From: ASC 450-20: Contingencies – Loss Contingencies

05-4 Accounting standards use two primary approaches to dealing with uncertainty in loss circumstances:

a. Recognition using a probability threshold

b. Measurement using a fair value objective.

05-5 [This Subtopic deals with uncertainty by requiring a probability threshold for recognition of a loss contingency and that the amount of the loss be reasonably estimable. FAS 146, paragraph B16][As noted in paragraph 450-20-30-1, when both of those recognition criteria are met, and the reasonably estimable loss is a range, it requires accrual of the amount that appears to be a better estimate than any other estimate within the range, or accrual of the minimum amount in the range if no amount within the range is a better estimate than any other amount.FIN 14, paragraph 3]

05-10 [The following are examples of loss contingencies that are discussed in this Subtopic: FAS 005, paragraph 4]

a. Injury or damage caused by products sold

b. [Risk of loss or damage of property by fire, explosion, or other hazards FAS 005, paragraph 4]

c. [Actual or possible claims and assessments FAS 005, paragraph 4]

d. [Threat of expropriation of assets FAS 005, paragraph 4]

e. [Pending or threatened litigation. FAS 005, paragraph 4]

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Financial Reporting Concepts: Definitions (cont'd)

- Definitions (cont.)
  - **Remote**: the probability of one or more specified future events occurring is slight.
  - **Probable**: The future event or events are likely to occur.
    - Under USGAAP this is, by convention (but not by rule), generally accepted to be 70% - 80% likely
    - Under IFRS this is specified to be "more likely than not" or 51% likely
  - **Reasonably Possible**: The chance of the future event or events occurring is more than remote but less than probable.

  - **Asset retirement obligation (ARO):** Legal obligations associated with the retirement of a tangible long-lived asset that result from the acquisition, construction, development, or normal operation of a tangible long-lived asset.

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Financial Reporting Concepts: GAAP for Contingent Environmental Remediation Liabilities

- Environmental Remediation Liabilities: ASC 410-30
  - Cost components <u>to be included </u>(410-30-30-11 through 30-15):
    - **All** incremental direct costs of the remediation effort NEW
    - Costs of compensation and benefits for those employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort.

  - Cost that should **NOT** be included:
    - Costs of services related to routine environmental compliance matters (unrelated to a past event)
    - Litigation costs involved with potential recoveries are not part of the remediation effort
      - shall be charged to expense as incurred until realization of the claim for recovery is considered probable and an asset relating to the recovery is recognized, at which time any remaining such legal costs shall be considered in the measurement of the recovery.
    - Potential recoveries or salvage value (include as an asset – don't net against liability)
    - Costs related to toxic tort claims or Natural Resource Damages claims. (ASC 410-30)

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“Sidebar” : Recent SEC Letters

- 2016: SEC questions management’s limitation of ASC 450 liabilities to a certain time horizon.

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- 2011: SEC questioned why management could not reasonably estimate a range of loss pertaining to multiple environmental liability cases. SEC required that the registrant explain how this determination was made and highlighting the most significant items considered (one site included in this request was the Lower Passaic River study area to the Diamond Alkali Superfund Site).

- 2010: SEC required a PRP in the Lower Passaic River study area to the Diamond Alkali Superfund Site to respond by including highly specific disclosures related to the site.

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"Sidebar" : Recent SEC Letters

- April 2016: SEC questions management's limitation of ASC 450 liabilities to a certain time horizon.

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Form 10-K for the Year Ended December 31, 2014
Consolidated Financial Statements
13. Contingencies, page 86

1. In your response letter dated December 21, 2015, you indicate that historically you were able to reasonably estimate probable losses for asbestos claims not yet asserted for a period of three years and, beginning in 2015, for a period of four years. You also stated that you are "not concluding that losses beyond these time periods will be zero. Rather there is sufficient unpredictability…impacting the number and nature of claims as well as the average cost that the Company has not been able to reasonably estimate what probable losses beyond such time period will be". We note the following:

    - ASC 450 does not provide bright lines with regard to time horizons in which ASC 450 judgments should be considered and applied. Therefore, we do not believe there is a conceptual basis for limiting an ASC 450 assessment to a certain time horizon. We believe your ASC 450 assessment should consider all claims without limitation to a specific time period. It is unclear how the ASC 450 assessment was considered for periods outside of the three or four year time horizons.

Resulted in a restatement

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New or Revised ASTM Standards

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- ASTM E2137-17: Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters

- ASTM E2173-16: Standard Guide for Disclosure of Environmental Liabilities

- ASTM (in development): Standard for Recognition and De-recognition of Environmental Liabilities

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The Pitfalls

Commonly Observed Pitfalls

#10 Misapplication of "Probable", "Reasonably Possible", & “Remote”

#9 Misunderstanding of “Reasonably Estimable”

#8 Omission of Life Cycle / End of Life Costs

#7 Unrealistic Estimates of Project Duration

#6 Timing Errors

Commonly Observed Pitfalls

#5 Assumptions Related to PRPs and Misalignment of Estimates to the Guidance

#4 Inappropriate Inclusion of Operational or Compliance or ARO Costs

#3 Omission of OM&M costs Inappropriately Included in Operational or Compliance Costs

#2 Buried Recoveries

#1 Lack of Auditable, Verifiable Support for the Estimate

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How We Help

Oak Advising & Consulting supports our clients with a variety of services related to environmental remediation liability and asset retirement obligation estimates including:

- Private industry:
  - Assessing audit readiness ("pre-audit") of environmental liability estimates;
  - Serving as a facilitator and "translator" for management (particularly environmental or engineering functions) during external auditor procedures or during purchase accounting periods;
  - Improving processes and controls related to auditor- or management- identified weaknesses;
  - Supporting training events for environmental liability managers.
- Public Accounting:
  - Providing external Specialist support for the audit of management's environmental liability and ARO estimates;
- Engineering:
  - Co-delivering remediation or ARO estimates to valued clients for financial reporting purposes.

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If you have questions about these Materials or the services mentioned, contact:

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