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# Reporting Contingencies: Environmental Liabilities

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**ABSTRACT**

*The dawn of environmental regulation in the late 1960's and its proliferation through the early 1980's resulted in a new regulatory climate for business and increased potential contingent liabilities. Recent efforts toward convergence with international accounting standards increase disclosure and improve transparency for decision makers but also impact financial reporting. This article uses a case study set in the context of potential liability under the federal Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA) to illustrate financial reporting with respect to uncertain environmental liabilities under current and proposed requirements of Financial Accounting Standard 5 Accounting for Contingencies (SFAS 5), now known as Accounting Standards Update 450 (ASU 450). Financial reporting under the proposed requirements provides increased transparency for users and more complete information upon which to make decisions.*

**Keywords:** Accounting for Contingencies; Environmental Liabilities; CERCLA

## INTRODUCTION

Accounting for contingencies is a complex task. Financial statement users require information about contingent risks to evaluate investment decisions. Accounting rules task management with estimating the amount of a loss and the probability that the company will be responsible for the loss. If a loss is probable and reasonably estimable, it must be accrued (Accounting Standards Codification (ASC) 450 *Accounting for Contingencies*, previously known as Statement of Financial Accounting Standards No. 5 [FASB, 1975]). The question is whether estimates are reasonable and disclosures are adequate. The Financial Accounting Standards Board (FASB) proposed changes to ASC 450 partly in response to concerns about past contingency disclosures. Evidence indicated a lack of disclosure of contingent liabilities until liabilities were in fact settled (Desir, R., Fanning, K., and Pfeiffer, R., 2010; Taub, S., 2004; Fesler, R. and J. Hagler, 1989). This suggested that contingencies were not disclosed when losses were probable and estimable. In addition, the provisions of International Accounting Standard No. 37 *Provisions, Contingent Liabilities and Contingent Assets* (International Accounting Standards Board, 1998) provided for disclosure of possible obligations in the notes to the financial statements, resulting in increased transparency for users and greater disclosure than the disclosure required by Generally Accepted Accounting Principles (GAAP). The movement toward convergence with international accounting standards increased focus on these differences. Finally, contingent liability provisions of FAS 141R *Accounting for Business Combinations* (now known as ASC 805) conflicted with the provisions of ASC 450. In response, the Financial Accounting Standards Board (FASB) proposed changes to ASC 450 *Contingent Liabilities*.

Proposed changes to ASC 450 *Contingent Liabilities* have been under review and in discussion since October 2008 (FASB, 2008a). Proposed changes result in part from a movement toward providing financial statement users with sufficient information to evaluate risk and help users estimate the amount, timing and certainty of future cash flows and are expected to result in requirements for increased disclosures in the notes to the financial statements. In addition, shifting perceptions of environmental risk can also result in increased sources of liability. Thus, the movement toward greater transparency in contingency reporting coupled with market sensitivity to environmental risk results in a changing environment for business and a need to recognize sources of risk and capture information for disclosure.

This paper examines financial reporting requirements under current and proposed contingent liability reporting standards and discusses changes in the market perception of responsibility for environmental risk. We use a case study to illustrate the thorny nature of these liabilities and to examine the resulting financial reporting obligations under current and proposed contingency reporting standards.

## ACCOUNTING FOR CONTINGENCIES

Disclosure of contingent liabilities is problematic. On one hand, investors need sufficient information to evaluate the amounts, timing and certainty of future cash flows; therefore material threats to future cash flows should be disclosed. On the other hand, companies question how much information is useful for decision makers. Disclosure about contingent events can do as much harm as good. In the case of lawsuits, disclosure can prejudice the outcome of a case. In addition, investors may hold back investment because of risks that never materialize. Expecting investors to possess sufficient skill and information to determine potential liability on their own may be asking too much. However, the movement toward convergence with international accounting standards, changes in GAAP, and shifting attitudes toward environmental risk all point toward increased transparency in a difficult reporting environment.

In accounting for contingencies, companies must comply with standards issued by the FASB and regulations of the SEC. FASB standards ASU 450 *Contingent Liabilities* (FASB, 2008b) and ASC 410-30 *Environmental Obligations* (FASB, 2010a) govern recognition of environmental liabilities. ASU 450 provides GAAP guidance for reporting contingent liabilities, requiring the recording of a contingent liability based on the likelihood of a potential liability, and requiring accrual if the liability is estimable and probable (FASB, 2008b). ASC 410-30 provides guidance on accounting for environmental remediation liabilities.[1] As required by ASU 450, accrual of a liability is required if information available before the financial statements were issued indicates that it is probable that an asset has been impaired or a liability incurred at the date of the financial statements and the amount is reasonably estimable. ASC 410-30 contains special provisions for environmental loss contingencies. Generally, if an entity believes it has no current obligation to remediate a condition with a probable or possible environmental impact, then no disclosure is required. However, if the entity is required to report the release of hazardous substances and begin a remediation study or if the assertion of a claim is deemed probable, then the entity must report the loss contingency regardless of outside agency involvement. Receipt of an EPA Information Request Letter normally will cause the liability to become probable (ASC 410-30-50-13 and ASC 410-30-25-15a). Finally, Statement of Position 96-1 (AICPA, 1997) *Environmental Remediation Liabilities* provides additional guidance on when environmental liabilities should be accrued and benchmarks for when environmental liabilities should be recognized.

SEC regulations relevant to environmental liabilities include SEC regulations S-K (SEC, 2000) and Staff Accounting Bulletin 92 (SAB 92) (SEC, 1993). SEC Items 101, 103, 303 and 503(c) in SEC regulation S-K are relevant to contingency reporting regarding the materiality threshold. Item 101 requires companies to disclose any material effect compliance with federal, state or local laws may have on capital expenditures, earnings, and competitive position. Item 103 requires disclosure of pending or contemplated legal proceedings that meet one of three materiality threshold conditions: the claim must be material to the business; or the amount of the claim exceeds 10% of a company's assets; or if the claim involves monetary sanctions and a government entity is a partner (unless the sanctions are anticipated to be less than $100,000). Item 303 requires management discussion and analysis to disclose any uncertainties that are reasonably likely to affect the company's liquidity or capital expenditures. Finally, Item 503(c) requires a discussion of significant risks. SAB 92 (SEC, 1993) was issued to promote the timely recognition of contingent losses and address the diversity in practice with regard to these disclosures (Roberts, R., 1995). The goal of these disclosures is to provide users with information to assess the amounts and timing of future cash flows and to move toward greater consistency in financial reporting.

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[1] ASU 410-30 cites the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, Resource Conservation and Recovery Act of 1976, the Clean Water Act, the Clean Air Act, the Toxic Substances Control Act, the Emergency Planning and Community Right-to-Know Act, and the Pollution Prevention Act of 1990 as important environmental laws and regulations that relate to this standard.

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The movement toward convergence between US GAAP and International Accounting Standards (IAS) resulted in inconsistencies regarding accounting for contingent liabilities within US GAAP. In December 2007, the FASB issued FAS 141R *Accounting for Business Combinations* (FASB, 2007) regarding accounting for mergers and acquisitions. FAS 141R required that contingent liabilities would be recognized at fair value, putting the standard at odds with guidance in ASC 450. In December 2008, the FASB issued Exposure Draft 1600-100 *Disclosure of Certain Loss Contingencies* (FASB, 2008a) to eliminate the inconsistent treatment of loss contingencies between FAS 141R and FAS 5. The exposure draft required disclosure if the chance of loss was more than remote, expanding the population of disclosed loss contingencies and also required enhanced disclosures including management's estimate of the maximum exposure to loss. Objections from industry centered primarily on the fact that disclosures could prejudice the outcomes of contingencies. The FASB responded with a revision in June 2010 (FASB, 2010b) requiring that management disclose known facts rather than predictions and that companies would also provide quantitative information to help users make their own assessments. The latest exposure draft retains the "probable" criterion for accruing a loss but also requires enhanced disclosures for contingencies by including a tabular reconciliation that explains the period to period change in contingency accruals by class of contingency and additional disclosures in the notes to the financial statements. The proposed standard requires that companies provide enhanced "over the life cycle" disclosures about loss contingencies determined to be reasonably possible or probable. Finally, the standard proposes that all companies provide information about even remote loss contingencies if the potential impact is severe. Again, public comment periods generated intense industry feedback. The final standard was due on October 31, 2010 with implementation by December 15, 2010; however, the FASB has postponed action and the standard is expected in the second half of 2011.

Proposed changes to ASU 450 move financial reporting toward greater transparency and help narrow the gap between GAAP and IAS. Changes in the standard were predicated by contingent liability recognition in SFAS No. 141(R)-1 *Accounting for Business Combinations* (FAS 141(R)-1), requiring accrual disclosure of the market value of environmental liabilities, creating an inconsistency in accounting for contingent liabilities between FAS 5 and proposed FAS 141(R)-1. Finally, changing political and social perceptions of environmental risk are evident in legislative climate change initiatives and in various state and regional reporting requirements, signaling a shift in perceived risk regarding the burden of environmental liability. The formation of state coalitions to require the reduction of corporate carbon emissions and the reflection of rising sea levels in property insurance rates all indicate a change in public perception. The heightened awareness of environmental risk and the movement toward increased transparency in contingency reporting result in greater demands for accountability.

Regulations by the FASB and SEC create a broad umbrella with the overall requirement that material risks to the company's financial position are required to be disclosed. The following section describes liability under the Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA). This section is followed by a detailed case study describing the sequence of events in being named a potential responsible party under CERCLA. Finally, we present required financial disclosures.

## THE COMPREHENSIVE ENVIRONMENTAL RESPONSE COMPENSATION AND LIABILITY ACT OF 1980

CERCLA Section 107 (CERCLA, 1980), the most comprehensive provision, authorizes the Environmental Protection Agency (EPA) and private parties to recover their cleanup costs. Potential responsible parties (PRP) are broadly defined and are designated as:

1. a current owner or operator;
2. a person who was an owner or operator at the time of the disposal;
3. a person who arranged for disposal or treatment; and/or
4. a person who transported hazardous substances to disposal or treatment facilities.

The law also provides that these PRP categories be liable for all costs of removal or remedial action; damages for injury to, destruction of, or loss of natural resources, including the assessment cost; and costs of any health assessment study plus interest.

CERCLA's liability provisions generally impose *strict*, *joint*, and *several* liability, especially if there is evidence of commingling of hazardous substances, making the government's case significantly easier than with an *intentional* or *negligence* standard. Thus there is no defense to liability merely because a party claims to have acted with reasonable care or in accordance with an industry standard. EPA has been able to sue a few PRPs at large Superfund sites and has secured court rulings that each PRP is responsible for all of the cleanup costs. On one hand, this makes EPA's enforcement process much simpler than having to allocate liability based on the amounts and impact of hazardous substances contributed to the site. On the other hand, this puts the burden on PRPs of seeking contributions from other parties that the EPA did not pursue.

The standard of causation in these cases is quite minimal, especially in multiparty sites. After an extensive records investigation, any type of documentation that would potentially link a PRP to the site, such as a transport manifest, triggers EPA to send an information request to that PRP. It is not uncommon for a company to receive an information request after sending empty drums to a disposal facility. EPA presumes that if drums were sent to a site where hazardous substances were released, the drums must have contained hazardous substances. Administratively, this shifts the burden of proof to the PRP to prove the contrary, transferring the cost to the PRP, generally resulting in settlement with EPA rather than litigation over a liability. EPA's goal is to encourage PRPs to agree to settle, sharing cost on a proportionate basis based on their contribution to the site.

Finally, CERCLA's liability provisions can be applied retroactively. For example, if a company sent empty drums to a recycling facility for disposal in the 1960's, almost two decades prior to the enactment of CERCLA, the company may likely find itself the recipient of an EPA information request and in the shoes of a PRP even though the disposal of those drums occurred in accordance with the law at the time of disposal.

On January 11, 2002, President Bush signed into law the "Small Business Liability Relief and Revitalization Act" (also known as the Brownfields Law)(Pub. L. No. 107-118). One element of the effort to provide relief for small businesses is the *de micromis* exemption (42 U.S.C. §9607(o)). In part, it provides that an entity would not be liable if they could demonstrate that the total material transported was less than 110 gallons of liquid or less than 200 pounds of solid material; and if all or part of the disposal occurred before April 1, 2001.

**Exhibit 1. CERCLA Liability**

**CERCLA Liability - 42 U.S.C. §107(a)**

**Potentially Responsible Parties (PRPs)**

- Current Owners and Operators
- Past Owners and Operators
- Transporters
- Generators (those who arranged for the disposal or treatment of hazardous substances)

**Nature of Liability**

- Strict: Liable without regard to fault or intention
- Retroactive: Liable for past waste disposal activities
- Joint and Several: Each PRP can be held responsible for all costs at a site.

**Defense – *De Micromis* Exemption – no liability if total material transported was:**

- < 110 gallons of liquid
- < 200 pounds of solid material
- Disposal occurred before April 1, 2001

We next review application of contingency reporting principles using a case study that includes a three year sequence of events. The case study is presented followed by disclosure in the financial statements and notes to the financial statements.

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## CASE STUDY - THE FACTUAL SETTING

This case begins as the company is notified that it is a PRP at a U.S. EPA "Superfund" site. The EPA asks the company to respond to an Information Request, explaining that the EPA is currently investigating the release of hazardous substances at the ABC Site. The EPA enclosed a poor copy of a shipping manifest showing the company's name and a list of hazardous substances that were disposed of nearly a decade ago.

Internal investigation reveals that all related documents were destroyed in accordance with the company's customary record retention policy. The company concludes that although they generate no hazardous waste, there was a small quantity of hazardous substances that were shipped nearly 10 years ago but no supporting documentation currently exists. The EPA information request requires a mandatory response within 30 days to avoid enforcement action, a possible fine of $32,500 per day, and possible criminal penalties.[2]

The ABC Site was used for storage of used oil and industrial process water. Violations concerned improper sealing of tanks and pipes and failure to maintain equipment. Hazardous substances[3] were found in secondary containment areas and were threatening groundwater. Substances included: Acetone, Arsenic, Barium, Benzene, Benzoic Acid, Benzyl Alcohol, Cadmium, Chromium, Lead, Mercury, Methyl Ethyl Ketone, Methylene Chloride, Naphthalene, Phenol, Pyrene, Selenium, Styrene, Tetrachloroethene, Toluene, and Xylene. At the time of the EPA Information Request, over 1 million gallons of wastewater and nearly 1,500 tons of sludge had been removed from the site at a cost of over $1.7 million. The total potential liability to PRPs was over $2.3 million and each PRP may be held strictly, jointly and severally liable for the entire amount.[4] This scheme of liability means that any responsible party can potentially be liable for the *entire* cost of remediating the site, notwithstanding that the party is responsible for only a small amount of the total hazardous substances at the site and did nothing improper.

**Exhibit 2. Superfund Site**

[2] Based on ASU 410-30-50-13 and ASU 410-30-25-15a "…Receipt of notification or otherwise becoming aware that an entity may be a potentially responsible party compels the entity to action. The entity must examine its records to determine whether it is associated with the site. If, based on a review and evaluation of its records and all other available information, the entity determines that it is associated with the site, it is probable that a liability has been incurred…" and should be recognized and/or disclosed in the notes.

[3] Related to Superfund: the definition of "hazardous substance" in CERCLA is broad; according to ASU it "…is any element, compound, mixture, solution or substance that, when released to the environment, may present substantial danger to the public health or welfare or the environment…" (ASU 410-30-20 Glossary); *See also* 42 U.S.C. §9601 (14) for the expanded definition in the law.

[4] Ibid. "Where liability is joint and several, any party deemed liable is potentially responsible for all of the associated costs. This scheme of liability means that any responsible party can potentially be liable for the entire cost of remediating the site, notwithstanding that the party is responsible for only a small amount of the total hazardous substances or waste at the site and did nothing improper."

After determining that the company did in fact have a legal liability to respond to the EPA Information Request letter, the company had to determine whether there was a valid basis for EPA to hold the company liable as a PRP and if so, to what degree is their potential liability and determine how this should be disclosed as a financial reporting obligation.

Perhaps the most difficult part of the analysis of potential liability is projecting an accurate or realistic estimate of liability. Obviously, since the law provides for strict, joint and several liability, the PRP may be responsible for the entire cost of $2.3 million. Yet practically, that is not the manner in which EPA resolves these cases. As noted above, the costs are generally spread out among the various PRPs in some reasonably proportionate manner with specific liability determined upon settlement. However, the process of reaching settlement can take many months or years. Each step along the way includes many variables including how many PRPs fall into the net, how many will agree to a proportionate share, how many will have the funds to pay their share, etc. Add to this uncertainty a possible shelter from liability such as the *de micromis* exemption (less than 110 gallons of liquid or less than 200 pounds of solid material); however, rarely do things fall squarely within the parameters of an exemption.

The company discussed here as an example is a case in point. One could argue that the company falls within the *de micromis* exemption; therefore, the possibility of liability is remote. However, the EPA could contend otherwise; therefore, the possibility of liability would be probable. Additionally, areas of potential liability not sheltered by this exemption include suits by third parties, citizen suits under CERCLA, or actions by states or local governments under state or local law potentially creating yet another contingent liability.

Specifically regarding this case, how does one realistically describe and measure the potential liability? If the PRP enters into a settlement agreement with the EPA or the EPA responds confirming that the exemption applies, one avenue of potential liability can be put to rest. Even if one successfully limits liability exposure with respect to the federal government, there remains the question of third party liability and possible state or local government actions. Perhaps the passage of time would give some solace, such as with a statute of limitation, but still a measure of uncertainty remains. It is in this legal context that we turn to the financial reporting aspects of this analysis.

## FINANCIAL REPORTING AND THE CASE STUDY

Following is the timeline for the company regarding the ABC Superfund site and the accounting for the contingent liability.

*Year 1.* At the end of year 1, the company determined that they shipped a small amount of a hazardous substance to the Superfund site ten years ago and that there was a remote chance that they were liable. Under current standards ASU 410-30-25-15a, if "…the entity determines that it is associated with the site, it is probable that a liability has been incurred. If all or a portion of the liability is reasonably estimable, the liability shall be recognized." However, the company's attorney believed that they satisfied the *de micromis* exemption; therefore, the company would avoid recognition and disclosure under current disclosure rules of ASU 450-20-50 (before revision); however, under the proposed Exposure Draft for Contingencies (ASU 450), the contingent liability would require disclosure even though it is remote, due to the severe impact that strict liability could impose on the company.

**Exhibit 3. Financial Statements and Notes Year 1**

| | **Balance Sheet** | | | **Income Statement** | | |
|---|---|---|---|---|---|---|
| | **ASU 450-20-50** | | | **ASU 450-20-50** | | |
| | **Current** | **Proposed** | | **Current** | **Proposed** | |
| Environmental Liabilities | n/a | n/a | **Operating Expenses** | n/a | n/a | |

**Notes to the Financial Statements**

**Current ASU 450**:

No disclosure needed.

**Proposed ASU 450**:

In Year 1, the company received an Information Request from the EPA pursuant to section 104 of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) of 1980. The Information Request stated that the EPA believed that hazardous substances at ABC Superfund site were generated by the company. The company was named as a potentially responsible party and was directed by the EPA to respond to the Information Request. We have determined that we did ship a minor quantity of hazardous substance to the site nearly ten years ago.

Corporate counsel believes that the company falls under the *de micromis* exemption (probability of liability is remote) due to the minor amount of hazardous substances the company has contributed to the site. ASU 450-20-50-1D *Disclosure Threshold* and ASU 450-20-50-1F *Disclosure Requirement* requires the company to disclose remote liabilities that could cause a severe impact to the company. The cost associated with the site to date is $1.7 million. Due to CERCLA laws of strict, joint and several liability, there is a remote chance that the company could be liable for the entire $1.7 million. Liability for the full amount would result in a severe impact on our financial statements.

Note that the end of paragraph one acknowledges that the company did ship hazardous substances. This statement presents another dilemma in that it is an admission against interest that could be used by EPA or other parties in an action against the company. Disclosures such as this were the source of much discussion over the past two years while the update was out for discussion.

*Year 2.* In Year 2, the company responded to the EPA in a timely manner avoiding penalties for a delinquent response. The company is one of several PRPs; however, management believes they fall under the *de micromis* exception. During the year, the EPA named the company as one of three PRPs to hold responsible for site assessment and remediation, putting a burden on the three PRPs for current costs incurred as well as the responsibility for the complete remediation of the site. The company was targeted by the EPA primarily because of its financial strength.

Total costs incurred through year two to remediate the site were $1.9 million with an estimate of $125,000 to $625,000 to complete remediation, resulting in a contingent liability estimate of $2,025,000 using the lower cost within the range. Due to the minor amount of hazardous substance contributed to the site, the company's attorney estimated that the company would be liable for 1%; therefore, $20,250 would need to be accrued by the company due to the probability of liability. Proposed Update ASU 450-30-50 would require the PRP to disclose a tabular reconciliation of the costs and also include the additional $500,000 from the range estimate and $2,004,750 (the remainder of the total $2,025,000) due to exposure from strict, joint and several liability.

The company along with the other two PRPs who were targeted by the EPA contact the remaining PRPs to determine the sharing of costs based on each companies' proportionate basis based on their hazardous substance contribution to the site. The company assertion of the *de micromis* exemption is ignored by the EPA at this time. According to ASU 410-30-25-15a the liability is probable and must be accrued.

By year-end, the proportionate basis had not been determined as several of the PRPs were no longer in business or did not have the ability to pay for remediation (recalcitrant PRPs). The company's legal costs incurred this year were $7,500 and their future estimate of legal costs is $10,000 related to the environmental issue.

**Exhibit 4. Financial Statements Year 2**

| | Balance Sheet | | | Income Statement | |
|---|---|---|---|---|---|
| | ASU 450-20-50 | | | ASU 450-20-50 | |
| | **Current** | **Proposed** | | **Current** | **Proposed** |
| Environmental Liabilities | $30,250 | $30,250 | **Operating Expenses** | $30,250<br>7,500 | $30,250<br>7,500 |

**Notes to the Financial Statements**:

**Current ASU 450**:

The company has been identified by the EPA as a potentially responsible party (PRP) as it relates to a multiparty Superfund site. The company is one of three PRPs targeted by the EPA to remediate the site. ASU 450-20-25-2 requires accrual of a loss contingency when it is probable that a liability has been incurred and the amount of loss can be reasonably estimated. The company has accrued $20,250 undiscounted as environmental remediation expenses plus $10,000 for estimated legal fees.
The company is seeking the *de micromis* exception; however, is unsuccessful at this time. Incurred legal fees related to the ABC Site were $7,500.

**Proposed ASU 450:**

The company along with two other companies were targeted by the EPA to remediate the ABC Superfund site located in City, ST. The company disposed of a minor amount of a hazardous substance ten years ago, creating the contingent liability. Total costs incurred to date to remediate the site are $1.9 million with an estimate of $125,000 to $625,000 more costs over the next year. The site is expected to be fully remediated by year 3. The Company is not the only PRP held responsible at the ABC site. The company has accrued $20,250 undiscounted as environmental remediation expenses and an environmental liability for 1% of the costs ($1,900,000) incurred to date plus 1% of estimated additional expenditures ($125,000) to remediate the site.
The company and the other two PRPs held liable by the EPA has hired an arbitrator to allocate the cost across all the PRPs. To date, the allocation process has been unsuccessful due to potentially recalcitrant PRPs.

Due to the nature of Superfund laws, the company could be held liable for the full amount ($2,025,000) plus $500,000 of additional estimated remediation costs under the strict, joint and several liability.

**Tabular Reconciliation**

| | |
|---|---|
| Accrual at December 31, year 1 | $ 0 |
| New loss contingencies recognized in year 2 | 20,250 |
| Minimum estimate of Legal fees | 10,000 |
| Increase for changes in estimates for loss contingencies recognized in prior periods | 0 |
| Accrual at December 31, year 2 | $30,250 |

The company incurred $7,500 in legal fees related to the environmental issue.

*Year 3.* By the end of year 3, the site was completely remediated for $2.35 million. The three PRPs were able to seek settlement arrangements with the majority of the other identified PRPs through outside mediation. The remaining PRPs agreed to share the costs proportionately based on their respective contribution of hazardous substances to the site. The recalcitrant share was allocated across the PRPs based on their pro rata share. All PRPs settled their debts by the end of the year. The company incurred an additional $10,000 of legal/arbitration fees during the year related to the environmental issue.

The EPA declined the *de micromis* exemption due to the timing of the disposal (after April 1, 2001). The company's proportionate share of the $2.35 million (including their share of the recalcitrant PRPs) amounted to $25,000. Total costs incurred in year 3 for the cleanup and legal fees were $35,000 of which $30,250 was accrued in year 2.


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**Exhibit 5. Financial Statements Year 3**

| | **Balance Sheet** | | | **Income Statement** | |
|---|---|---|---|---|---|
| | **ASU 450-20-50** | | | **ASU 450-20-50** | |
| | **Current** | **Proposed** | | **Current** | **Proposed** |
| Environmental Liabilities | 0 | 0 | **Operating expenses** | $4,750 | $4,750 |

**Notes to the Financial Statements**

**Current ASU 450**:

The company settled its responsibility related to remediation costs at a Superfund Site as well as Legal fees associated with remediating the Site.

**Proposed ASU 450**:

Last year, the company along with two other companies was targeted by the EPA to remediate the ABC Superfund site. The company disposed of a minor amount of a hazardous substance ten years ago, creating the contingent liability. Total costs incurred to date to remediate the site were $2.35 million. By year end, the Site was fully remediated.

Last year an outside arbitrator was hired to allocate the cost across all the PRPs based on the proportionate share of hazardous substances that were disposed at ABC. The company's share of the cost to remediate the site (including a prorated share of recalcitrant PRPs) is $25,000 (an increase of $4,750 over last year). At year end, all of the PRPs have settled their debts.

Additional legal defense costs incurred by the company related to the site were $10,000.

**Tabular Reconciliation**

| | |
|---|---|
| Accrual at December 31, year 2 | $30,250 |
| Additional Year 3 Remediation Costs | 4,750 |
| Total Accrual at December 31, year 3 | 35,000 |
| Settlement amount | (35,000) |
| Contingent liability at December 31, year 3 | $ 0 |

The Company incurred $10,000 in legal fees related to the environmental issue which were accrued last year.

The presentation above illustrates that proposed update ASU 450 provides financial statement users with comparatively more complete information upon which to base decisions. The tabular reconciliation details changes in the accrual through time. The increased transparency also serves to increase confidence in financial reporting and in managements' representations.

## CONCLUSION

The primary objective of financial accounting is to provide information to help investors and creditors in assessing the amounts, timing, and uncertainty of current and future cash flows. The purpose of the proposed change in ASU 450 *Accounting for Contingencies* is to improve communication to financial statement users regarding the contingent risks companies face. In the past, these risks were not reported on a timely basis. Due to the difficulties involved in estimating the amount and probability of contingent liabilities, proposed update to ASU 450 stopped short of requiring accrual but does require increased disclosure and reconciliation in the notes to the financial statements. Disclosure in the notes will provide users additional information in order to make their own estimates of risk.

Environmental obligations can have a severe impact on future corporate cash flows regardless of due diligence on the corporation's part. The proposed update to ASU 450 improves disclosure of contingent liabilities including environmental obligations, to alert investors of even remote liabilities if the impact on the entity is severe. As the case study shows, the proposed change only affects the notes by increasing disclosure of the contingency. The trend toward more disclosure in financial reporting is expected as FASB attempts to align GAAP with IFRS.

Over the past fifty years, environmental impacts have increased in importance in all aspects of business; from carbon emissions to property insurance rates. With the introduction of CERCLA, the EPA has put the burden on PRPs to remediate hazardous substances that endanger humans and the environment. The environment will continue to be a risk to be managed in the future. The first step to reduce risk is proactive management and tracking of the disposal chain. Management begins by careful selection of disposal companies and continuous tracking of waste generation and disposal. Constant oversight will protect against expensive clean-up efforts and reduce the likelihood of loss. The second step, if possible, is to reduce the generation of hazardous substances through product/process redesign. Lastly, the realization that "full disclosure" is becoming more likely in the future serves to motivate management to design and implement controls to reduce the likelihood of negative disclosures. Effective controls mitigate risk and should make the company more competitive as stakeholders see the benefit of proactive management.

## SUGGESTIONS FOR FUTURE RESEARCH

As we move toward convergence with international accounting standards, additional information regarding information quality and compliance with current US GAAP financial reporting requirements provides evidence-based information for discussion and policy making. As deliberations continue regarding disclosure of contingent liabilities, additional information regarding the timing of disclosure of contingent liabilities and their outcomes would be of interest. Research into contingency reporting in IFRS markets and related stock market effects would also be of interest. Revenue recognition, financial instruments and leases all pose significant changes to reporting and to operational decisions for US companies. As these issues are deliberated, a full understanding of the current landscape of US reporting will help insure better decision making and more robust financial reporting.

## AUTHOR INFORMATION

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**NOTES**


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