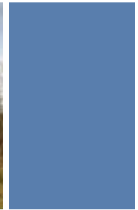


# Gradient Corporation



## CLIENT ALERT

### Environmental Contamination Liability Disclosure Changes – The First Shoe Drops

On June 5, 2008, the Financial Accounting Standards Board (FASB) released a draft proposed statement, *Disclosure of Certain Loss Contingencies* (File Reference No. 1600-100), which amends the FASB Accounting Standards (FAS) 5 (*Accounting for Contingencies*) and FAS 141(R) (*Business Combinations*). Effective December 15, 2008, the proposal is the first part of a two-part project to comprehensively reconsider financial accounting treatment of contingencies. This proposal addresses disclosure of loss contingencies beyond the accounting accrual values; the second part of the project will address the accrual values. The proposal comment period ends August 8, 2008.

The FASB proposal will substantially expand the information about environmental contamination liabilities that companies must develop and publicly disclose. The primary new requirements include:

- More cost estimates - Cost estimates must be prepared for all disclosed liabilities. The option to declare that an estimate cannot be made will no longer be available.
- New, detailed table of estimates - Cost estimates that were previously reported as bottom-line net values will now need to be broken down in more detail.
- More explanation - Expanded discussion about disclosed liabilities will be required.
- More disclosure - The universe of liabilities that must be disclosed will be expanded.

These new requirements are described below.

#### Background

Loss contingencies, as used in FAS 5 and the FASB proposal, are liabilities related to existing conditions whose values are contingent on future events, such as collection of receivables, pending litigation, and future costs related to environmental contamination (*e.g.*, site investigation and remediation, natural resources damage assessments, and private party lawsuits). Environmental contamination liabilities are nearly always treated as loss contingencies because the values are invariably highly uncertain at the time of the initial discovery that triggers liability recognition, and many years often pass between discovery and full resolution of the liability. Full resolution does not occur until the regulatory agencies confirm that all cleanup requirements have been met, all natural resource damage claims have been resolved, and the company is unaware of any site-related private party lawsuits.

Under the FAS 5 standards for loss contingency accounting, an accrual is required if a loss is probable and the amount of the loss can be reasonably estimated. The amount of the accrual is the most likely value or, if no value is more likely than any other, the minimum value. Additionally, if there is at least a reasonable possibility that losses beyond those accrued will be incurred, FAS 5 requires either disclosure of the potential range for such losses or a declaration that an estimate cannot be made. The FASB is currently evaluating FAS 5, and the June 2008 proposal is the first product of that effort.

Over the past several years, the FASB has been modifying the treatment of certain types of loss contingencies, generally requiring both more disclosure and changing the manner in which loss contingencies are valued. Two notable examples of these recent changes are the FASB standards for asset retirement obligations in FAS 143/ FASB Interpretation (FIN) 47, and for business combinations in FAS 141(R), both of which require that loss contingency estimates reflect fair market value. Other loss contingencies, such as liabilities related to environmental contamination that are not acquired through purchase of another business after December 15, 2008 (the effective date for FAS 141(R)), are disclosed and valued using the approach described in FAS 5.

### **Key Requirements of the FASB Proposal**

#### *More Cost Estimates will be Required*

The FASB proposal eliminates the current option of declaring that an estimated value for a disclosed liability cannot be made. The rationale for this change is that even highly uncertain information is better than no information. Companies will thus be required to produce and disclose estimates of the maximum loss exposure regardless of the available information. In contrast to the required accrual amount (currently either the most likely or minimum value), the proposed disclosure for liabilities that do not meet the standards for accrual is the maximum value.

#### *Table of Estimates will be Required*

The FASB proposal requires a table summarizing all loss contingencies at the beginning and end of the period for each period in which an income statement is produced. The table must explicitly show at least the following four entries:

- New loss contingencies recognized since the prior reporting period;
- Increases of estimates for previously recognized loss contingencies;
- Decreases due to either a) changes of estimates for previously recognized loss contingencies or b) removal of previously recognized loss contingencies; and
- Decreases due to payments or other forms of settlement on previously recognized loss contingencies.

Remediation liabilities may be grouped together in one row on this table. Liabilities recognized under FAS 141(R) (those loss contingencies acquired in a business combination after December 15, 2008), however, must be shown separately from those recognized under FAS 5. The FASB proposal also requires separate disclosure of the gross liability and possible offsets, such as insurance or indemnification, rather than disclosure of only a net value. This separation is already required for loss contingencies recognized under FAS 141(R).

Additionally, if the company believes that the amount of a claim (such as the government's estimate of natural resources damages) does not reflect the likely actual liability, the FASB proposal allows disclosure of an alternative estimate in addition to the claimed amount. For example, if the government asserted a \$25 million claim for natural resources damages, but the company believed the claim would most likely settle for \$10 million, the company must disclose the \$25 million claim and may also disclose its alternative \$10 million estimate.

#### *More Explanation will be Required*

The FASB proposal expands the list of issues related to loss contingencies that must be discussed in financial reports, including:

- Origin, legal or contractual basis, current status, and anticipated resolution timing;
- Factors likely to affect the ultimate outcome, and potential impact of those factors on the outcome;
- Qualitative assessment of the most likely outcome; and
- Key assumptions for both the quantitative and qualitative assessment of the liability.

The proposal allows these issues to be addressed for the same groups of loss contingencies used in the newly required summary table. It may, however, be difficult to meet the spirit of the proposal if all remediation liabilities are described as a group, rather than individually. Additionally, a qualitative discussion of all “significant activity” reflected in the summary table is required, though what constitutes “significant activity” is not defined.

#### *More Liabilities must be Disclosed*

The FASB proposal requires disclosure for all loss contingencies except those with a remote likelihood of loss and those with no asserted claim (*e.g.*, no regulatory action or lawsuit). There are, however, exceptions to these exceptions. The provision most likely to apply to environmental contamination liabilities is that situations for which no claims have been asserted must be disclosed if a) it is probable that a claim will be asserted and b) the loss likelihood if a claim is asserted is “more than remote.”

For example, consider a property that has not been investigated or otherwise brought to the attention of a regulatory agency, but where the company is aware of potential contamination due to the historic site use. For part **a)** of this two-part test, the company must evaluate whether it is probable that some type of claim, such as a regulatory requirement for remediation, may someday be asserted. For part **b)** of this test, the company must determine if there is a “more than remote” chance they will need to spend money dealing with the site in the event that a claim is asserted. The FASB’s proposed “more than remote” requirement is more stringent than its current standard which only requires a “reasonable possibility” of a loss.

The proposed disclosure requirement will thus include more situations than the current requirements and, like the current standard, will apply to all properties worldwide. The impact of this expanded disclosure proposal may be substantial because once a liability that requires disclosure is recognized, the company must also prepare an estimate of the maximum value of that liability, include that estimate in the required table, and discuss the various issues related to that liability described above.

#### **Materiality**

As with many FASB Statements, the provisions of this proposal do not need to be applied to immaterial items. The FASB has not, however, provided any additional guidance on the issue of how materiality should be determined. Various organizations have proposed that companies be required to assess materiality based on the aggregation of all environmental liabilities, but neither the FASB nor the Securities and Exchange Commission have ruled on this issue. As shown by a recent Gradient industry survey, companies are evenly split on whether they judge materiality on a site-by-site basis or in aggregate over broad classes of liabilities.

#### **Conclusions**

The FASB proposal substantially expands the information that must be developed and publicly disclosed for environmental contamination liabilities. Information that was previously reported as a bottom-line net value, or not reported at all, will now need to be reported in more detail. Additionally, companies may face the daunting task of developing liability estimates on the basis of extremely limited information. Although based on good intentions regarding financial transparency, the proposal requires companies to generate liability estimates that may be so highly uncertain as to be potentially misleading for the same investors they are intended to enlighten.

When the FASB releases its proposal for the second phase of the overall contingency accounting (FAS 5) review project, companies can expect sweeping changes in standards for environmental contamination liability accruals. If the FASB continues the trend established in recently released standards for asset retirement obligations (FAS 143/FIN47) and loss contingencies from business combinations (FAS 141(R)), companies can expect that the accrual value will be the fair value, rather than the most likely or minimum value as currently specified in FAS5.

**Further Information**

The FASB proposal may be obtained online at: [http://fasb.org/draft/ed\\_contingencies.pdf](http://fasb.org/draft/ed_contingencies.pdf). Alternatively, the FASB will supply one paper copy free of charge upon written request for Product Code No. E195, sent to:

Order Department  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

Parties wishing to comment may do so by sending an e-mail to [director@fasb.org](mailto:director@fasb.org), subject File Reference No. 1600-100 or by mail to “Technical Director – File Reference No. 1600-100” at the above address. Comments must be received by August 8, 2008.

The FASB also intends to hold one or more public roundtable meetings to hear directly from interested parties. If you are interested in participating, please e-mail [director@fasb.org](mailto:director@fasb.org) no later than July 25, 2008.



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