Remarks Of

Richard Y. Roberts
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.

Environmental Liability Accounting Developments

American Bar Association
Fourth Annual Joint Conference On
Environmental Aspects of Corporate & Real
Estate Transactions
New Orleans, Louisiana
June 10, 1993

---

*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

ENVIRONMENTAL LIABILITY ACCOUNTING DEVELOPMENTS

I. INTRODUCTION

As society strives to maintain and to improve our environment, costs are imposed that may need to be disclosed to investors under our federal securities laws. These environmental costs have reached staggering proportions in recent years and are one of the critical issues facing businesses today. Compliance costs associated with regulations restricting development and limiting harmful emissions can and often do have a material effect on the operating expenses of a company. Moreover, environmental laws can impose large liabilities, particularly with respect to past generators of waste materials.

While the aggregate numbers concerning potential environmental costs are staggering, what is even more frightening is the massive amount of acknowledged environmental cost that has yet to be reflected in corporate financial statements. Despite the growing importance of environmental issues, a recent survey by Price Waterhouse indicates that 62% of the issuers responding to the survey have known environmental liability exposures not yet recorded in their financial statements.[1] Thus, environmental liability, if not already, will soon become a prominent concern for virtually all securities marketplace participants.

II. Shareholder Proposals

One area that I wish to mention briefly is the shareholder proposal process. Concern about environmental issues is manifest in the shareholder proposals that issuers may be required to consider as they prepare for their annual meetings each year, particularly since the grounds for excluding such proposals sometimes change

---

[1] Accounting for Environmental Compliance: Crossroad of GAAP, Engineering, and Government, a survey of corporate America's accounting for environmental costs conducted by Price Waterhouse (1992, second in a series), at 1 ("Price Waterhouse Survey").

over time. Shareholder proposals often attempt to link environmental concerns with the economic well being of an issuer, and, if successful, such proposals may establish new directions for the issuer.

One such example was the D.C. Circuit Court of Appeals case of Roosevelt v. DuPont where a shareholder was partially successful in challenging a lower court decision allowing the exclusion of a proposal that would require DuPont to accelerate the phase out of chlorofluorcarbon ("CFC") production before 1995.[2] CFCs, as we all know, have been linked to the depletion of the ozone layer, and DuPont is the largest producer of CFCs in the world.

Another recent development in the shareholder proposal environmental area that I wish to mention is the decision issued earlier this year by the U.S. Court of Appeals for the Second Circuit in United Paperworkers International Union v. International Paper Co.[3] In this case, the appeals court affirmed a lower court decision that International Paper Company committed proxy rule violations by materially misrepresenting its environmental record in responding to a shareholder proposal urging adoption of the Valdez Principles. Further, the appeals court ruled that the company must disclose and describe the United Paperworkers decision in its 1993 proxy materials.

I anticipate that the combination of the Roosevelt and United Paperworkers decisions will cause issuers, if they did not already, to treat with the utmost care shareholder proposals in the environmental liability area and the issuer response thereto. I suspect that shareholder proposals on environmental responsibility will continue to increase. In particular, I anticipate that more shareholder proposals will

---

[2] 958 F. 2d 416 (D.C. Cir. 1992).

[3] Fed. Sec. L. Rep. (CCH) ¶97,342 (Feb. 12, 1993).

be forthcoming requesting issuers to endorse the Ceres Principles on corporate environmental responsibility.[4]

III. COMMISSION REVIEW DEVELOPMENTS

As everyone here is aware, the federal securities laws are designed to promote full disclosure of material facts. While there are those that advocate that the Commission should attempt to enforce the securities laws in a manner that effectively regulates corporate environmental conduct, I am more comfortable with the traditional Commission role of pressing for clear disclosure of all environmental information that is economically material to the issuer.[5]

At the Commission, the large dollar amounts of anticipated environmental liability costs have produced increased pressure to monitor the adequacy of issuer disclosure. During the past several years, the staff of the Commission's Division of Corporation Finance has been looking closely at the adequacy of environmental disclosure in connection with its review of filings. I expect this scrutiny to continue generally and even to become more intense with respect to issuers that are in industries which are significantly effected by environmental risks such as pulp and paper companies, primary metal manufacturers, and industrial organic chemical manufacturers, among others. When the staff finds material omissions or deficiencies relating to environmental matters, it will continue to request corrective disclosure and, in egregious cases, may refer the matter to the Division of Enforcement.

---

[4] Ceres, the Coalition of Environmentally Responsible Economies, apparently is a Boston-based not-for-profit group. Its 10-point code was originally known as the Valdez Principles. Recently Sun Company, Inc., became the first Fortune 500 company to give official recognition to the Ceres environmental code. See "Sun Company endorses Ceres Principles model," Corporate Secretary, a publication of the American Society of Corporate Secretaries (April 1993), at 5.

[5] See Ferman, "Environmental Disclosure and SEC Reporting Requirements," 17 Delaware Journal of Corporate Law 483 (1992).

In order to enhance the disclosure in the environmental liability area, a dialogue has been developed between the staffs of the Commission and the Environmental Protection Agency ("EPA"). The Commission now utilizes EPA staff to help train Commission staff in the environmental liability disclosure review area. Further, through an informal understanding, Commission staff receives from the EPA lists of all companies that have been named as PRPs on hazardous waste sites. Information also is received concerning companies subject to the cleanup requirements under RCRA. Commission staff currently utilize this information in its review process.

In the past, Commission staff has considered formalizing this dialogue through the execution of a memorandum of understanding with the EPA. It is my understanding that the pursuit of such an agreement either is being or will be renewed. I believe that a formal memorandum of understanding could be beneficial to both agencies in fulfilling their statutory responsibilities, and I hope that the new negotiations will be successful.

IV. Accounting Developments

Environmental matters also of course have accounting implications for issuers, and it is my intention today to focus primarily on certain recent accounting developments in the environmental liability area. Generally accepted accounting principles ("GAAP"), specifically Statement of Financial Accounting Standards No. 5 "Accounting for Contingencies" ("SFAS 5"), require that an estimated loss from a loss contingency must be accrued by a charge to income if it is probable that a liability has been incurred and that the amount of the loss can be reasonably estimated. FASB Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss" ("FIN 14"), states that if the estimated amount of loss is within a range of amounts, and some amount within the range appears to be a better estimate than any other, then that amount should be accrued. FIN 14 adds that when no amount within the range is a better estimate than any other amount, the minimum amount in the range should be accrued.[6]

Although there has been some improvement in this area, it is still my impression that accruals concerning environmental liability are not showing up in the financial statements as quickly as I believe that they should be. Judging from the 62% figure that I cited earlier, this concern appears to be well-founded.[7]

However, the Price Waterhouse Survey does indicate some improvement in this area. Expensing costs as they are paid during the cleanup process, referred to as "pay-as-you-go" accounting, is not typically considered GAAP unless the amounts involved are not material. The percentage of survey respondents indicating that they used the "pay-as-you-go" method decreased from 28% in the previous survey to 15% in the current survey.[8] Although there needs to be even more improvement, I am encouraged by the reduction in the use of "pay-as-you-go" accounting and by the increase in the use of accrual accounting.

One recent accounting development in the environmental liability area was the meeting earlier this year of the Financial Accounting Standards Board's ("FASB") Emerging Issues Task Force ("Task Force"). On the Task Force's meeting agenda were a variety of accounting issues, including two issues relating to the recognition and measurement of environmental liabilities. Those accounting issues were: (1) under what circumstances is it appropriate to include recoveries in measuring the amount of a probable loss, and (2) under what circumstances is it acceptable to discount an environmental liability.

---

6 See infra note 13.

7 See supra note 1.

8 Price Waterhouse Survey, supra note 1, at 12.

Another recent accounting development in the environmental liability area that I wish to discuss in conjunction with this recent Task Force meeting is Staff Accounting Bulletin No. 92 ("SAB") which was issued by Commission staff earlier this week. In many respects, the SAB and the recent Task Force action should be interpreted collectively.

The SAB, which sets forth the staff's interpretation of GAAP regarding contingent liabilities, will effect in particular those issuers that may have incurred environmental liabilities. The SAB's guidance is intended to promote timely recognition of contingent losses and to address the diversity in practice with respect to the accounting and disclosures in this area. Hopefully, publication of the SAB will improve this practice.

As I indicated earlier, the diversity in accounting practice regarding the recognition of contingent liabilities was addressed recently by the Task Force through Task Force Issue 93-5, "Accounting for Environmental Liabilities." The consensuses reached by the Task Force eliminated the need for the SAB to discuss the interpretations of Commission staff regarding several measurement issues involving environmental liabilities. Issuers are expected to follow the positions agreed upon by the Task Force, or to justify any departure from any consensus reached.

The SAB presents the view of Commission staff regarding: (1) the manner in which a contingent and any related asset representing claims for recovery should be displayed in the financial statements; (2) the appropriate discount rate to be used for recognition of a contingent liability presented at its present value to reflect the time value of money; and (3) the disclosures that are likely to be of particular significance to investors in their assessment of these contingencies. The most controversial aspect of the SAB is likely to be the view of the Commission staff that contingent liabilities should be displayed on the face of the balance sheet separately from amounts of claims for recovery from insurance carriers or other third parties.

As in the Task Force meeting that I alluded to earlier, two significant issues effecting the measurement and disclosure of contingent liabilities -- offsetting and discounting -- are discussed in particular in the SAB, and I will now address each of these issues.

A. Offsetting

Rather than recognize and display separately the liability representing the likely settlement amount of a contingent liability and the asset representing the amount likely to be recovered from the insurance carrier, many issuers recognize the liability net of the insurance claim. This practice is equivalent to "offsetting" the insurance receivable against the contingent liability.

The Task Force reached a consensus on Issue 93-5 that an environmental liability should be evaluated independently from any potential claim for recovery. Under that consensus, any loss arising from an environmental liability should be reduced only when a claim for recovery is probable of realization. However, the consensus did not address whether probable assets and probable liabilities could be netted to a single amount for balance sheet display. As I indicated earlier, the SAB does not permit such netting for the vast majority of situations.[9]

In the view of Commission staff, presentation in the balance sheet of the gross, rather than net, amount of the liability most fairly presents the potential consequences of the contingent claim on the issuer's resources. For example, the issuer's liquidity may be effected materially if cash settlement of the liability must be made prior to receipt of insurance proceeds. Separate display of the gross liability and the amount

---

[9] The exception being that offsetting is permissible when the conditions of FIN 39 are met. See infra note 10. This will probably be a rare circumstance.

likely to be recovered highlights the different factors that effect these two estimated outcomes and the related cash flows. Offsetting the two components may leave investors unaware of the magnitude of the liability and may lull them into a less rigorous consideration of the legal sufficiency of the issuer's claims for recovery and the creditworthiness of the party from whom recovery is anticipated.[10] Separate display would not effect the measurement of income or stockholders' equity.

Separate display of the claim for recovery is expected to lead to more rigorous consideration of the uncertainties effecting realization of that claim. The SAB's limitation on offsetting is consistent with the requirement enunciated in the recent Task Force consensus that financial statement preparers must evaluate separately the circumstances under which the amount deemed recoverable from an insurance carrier or other third party may qualify for recognition as an asset. In my opinion, the SAB is also consistent with current accounting literature, in particular APB 10 and the FASB's recent interpretation regarding setoffs as contained in FIN 39.[11]

---

10 The accounting literature generally proscribes the offsetting of assets and liabilities except where a right of setoff exists. Accounting Principles Board Opinion No. 10, "Omnibus Opinion --1966" ("APB 10"), states that "[i]t is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." This general proscription was strengthened by the FASB in a recently issued interpretation, Financial Accounting Standards Board Interpretation No. 39, "Offsetting of Amounts Relating to Certain Contracts" ("FIN 39"). FIN 39 indicates that the prohibition on setoff in the balance sheet should be applied more comprehensively than it may have previously been in practice.

Paragraph 5 of FIN 39 states that a right of setoff exists when all of the following conditions are met:

a. Each of the two parties owes the other determinable amounts.
b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
c. The reporting party intends to set off.
d. The right of setoff is enforceable at law.

11 See supra note 10.

I know there are many issuers that presently recognize contingent liabilities reduced by an undisclosed setoff of claims for recovery which are probable of realization. The SAB indicates that Commission staff will not object if an issuer continues to account for a claim for recovery that is probable of realization as an offset against the contingent liability, rather than display it within total assets, until the effective date of FIN 39. I understand that the FIN 39 standard is effective for financial statements for fiscal years beginning after December 15, 1993. In the interim, however, issuers are advised to disclose in a note to the financial statements the gross amount of probable recoveries that is netted against the contingent liability.

B. Discounting

A second issue of great significance to issuers that is discussed in the SAB is the ability to recognize an estimated liability at its present value, rather than at the gross amount expected to be payable. Because the ultimate settlement of environmental liabilities may not occur for many years, the effect of discounting the liability to reflect the time value of money may be quite important to some issuers.

The Task Force reached a consensus on Issue 93-5 that discounting an environmental liability for a specific clean-up site to reflect the time value of money is appropriate only if the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for that site. However, the Task Force could not reach a consensus on the appropriate discount rate to be used. Commission staff have chosen to limit the discount rate to one no higher than the rate on risk-free monetary assets.[12] That rate is objectively determinable, and this should

---

12 Paragraph 4(a) of Statement of Financial Accounting Standards No. 76, "Extinguishment of Debt," indicates that risk-free monetary assets are limited to direct obligations of or obligations guaranteed by the U.S. government or securities backed by U.S. government obligations.

enhance comparability of financial statements between issuers. The SAB only establishes a ceiling at the rate on risk-free monetary assets.

C. Other Measurement Issues

The SAB also provides guidance on the accounting for joint and several liability where a reasonable basis for apportionment of costs among responsible parties exists and another responsible party may not fully pay costs apportioned to it. The SAB advises issuers to recognize a liability pursuant to SFAS 5 for costs in excess of the originally apportioned costs if it becomes probable that one or more parties will not pay its share of the costs.

Commission staff have been concerned for some time that some issuers may have delayed recognition of a contingent liability until a single amount was determinable. The SAB reminds issuers that liabilities should be recognized in accordance with FIN 14.[13] The SAB expresses the staff's view that recognition of a loss equal to the lower limit of the range is necessary even if the upper limit of the range is uncertain.

The SAB further identifies factors that issuers should consider in estimating the amount to accrue as a liability. Certainly the measurement should be based on currently enacted laws and regulations using existing technology, rather than on assumptions that environmental laws will change or that an undeveloped or unidentified technology will enable the issuer to reduce the ultimate clean-up cost.

D. Disclosure Matters

Moreover, the SAB discusses disclosure requirements regarding loss contingencies. It provides examples of disclosures that issuers should consider to ensure that financial statements are not misleading and to inform investors fully regarding the range of reasonably possible outcomes that could impact the issuer's financial condition, results of operations, and liquidity.

---

13 See supra note 6.

The SAB refers to interpretive guidance previously published by the Commission. In addition to that guidance, the SAB identifies specific items that may warrant disclosure in certain situations that involve environmental liabilities. The additional disclosures recommended in the SAB are intended to elicit more specific and concrete information that will enable investors to intelligently evaluate the nature and scope of the contingency. Too often, disclosures regarding contingencies are overly general, do not fully convey the nature and magnitude of these contingencies, and do not clearly explain unusual developments or emergent trends that may effect an investor's assessment of the likely outcome. Finally, the SAB discusses appropriate disclosures concerning site restoration, environmental exit costs, and loss contingencies assumed in a business combination.

While the SAB is not a rule or interpretation of the Commission but represents the interpretations and practices followed by the Commission's Division of Corporation Finance and the Office of the Chief Accountant, I agree with the staff positions set forth in the SAB and wholeheartedly endorse its publication. I am pleased that the SAB has finally been issued, and I am of the opinion that its publication will assist practitioners in the environmental liability accounting area. I strongly recommend that practitioners in this area carefully review the SAB.

Identifying and interpreting environmental risks will continue to challenge the accounting industry. Accountants and attorneys should increase their efforts to assess the proper financial statement presentation and disclosure of environmental contingencies. The publication of the SAB should be helpful in this regard. Hopefully, as the spotlight on environmental issues becomes more focused, as cleanup technology and equipment improve, as estimating cleanup costs becomes easier, and as insurer coverage litigation consistency is achieved, earlier recognition of environmental liabilities and appropriate treatment of potential third party recoveries in financial statements will result.

V. CONCLUSION

It is clear that aggressive enforcement of environmental laws will increase in the 1990s. "Environmental due diligence" is a phrase that will grow increasingly familiar to the attorneys that represent both public issuers and investors.

I am pleased to observe the heightened awareness of the need for, and the improvements in, the practice of environmental liability accounting that have apparently taken place. This is reflected in the Price Waterhouse Survey where 23% of the respondents reported that they have empowered a board committee to oversee the issuer's environmental compliance, up from 14% in the prior survey. One-third of the respondent issuers also now have written environmental accounting policies, up from only 11% in the previous survey. Further, 26% of the respondents now disclose their environmental accounting policy in the accounting policies footnote to their financial statements — a significant increase over only 4% in the prior survey.[14] I hope that this progress continues.

In conclusion, I challenge each of you here today to acquaint yourselves with the environmental regulations and with the accounting literature regarding contingent losses, including the SAB, and to focus seriously on whether your employer or client has adequately disclosed and accounted for the short-term and long-term effects of environmental laws on their operations.

---

[14] See Price Waterhouse Survey, supra note 1, at 1.