Chapter 26 - Environmental Costs

Authoritative Sources

FAR 31.205-7 Contingencies

FAR 31.201-2 Allowability

FAR 31.201-3 Reasonableness

FAR 31.201-4 Allocability

FAR 31.201-5 Credits

FAR 31.205-3 Bad Debt

FAR 31.205-15 Fines, Penalties and Mischarging

FAR 31-205-47 Costs Related to Legal and Other Proceedings

This chapter addresses the following topics:

26-1 Summary

Environmental costs are normal costs of doing business and are generally allowable costs if reasonable and allocable. Some environmental costs must be capitalized when the incurrence of such costs improves the property beyond its acquisition condition or under certain circumstances when the costs are part of the preparation of the property for sale. If environmental clean-up efforts resulted from contamination caused by contractor wrongdoing, the clean-up costs are not allowable. Environmental costs may be subject to future recoveries from insurance companies and other sources, which may not be reasonably predictable at the time the environmental

clean-up costs are paid. Some of the sources of recovery may be unknown when the contractor pays for environmental clean-up costs. As such, clean-up costs claimed or forecasted are usually not reflective of the contractor's ultimate liability for the costs. Therefore, the forecasted costs should be treated as contingent costs subject to FAR 31.205-7, Contingencies. Also, any otherwise allowable incurred environmental clean-up costs should be accepted contingent upon the Government sharing in any future recoveries from insurance policies or other sources. Advance agreements should be recommended to protect the Government's interests in any future recoveries of clean-up costs reimbursed by the Government.

26-2 Types of Environmental Cost

Environmental costs include costs to prevent environmental contamination, costs to clean up prior contamination, and costs directly associated with the first two categories including legal costs. Costs associated with fault-based liabilities to third parties are not environmental costs (see 26-12).

26-3 Cost Principles Applicable to Environmental Cost

The costs incurred to clean up environmental contamination are considered to be normal business expenses. The primary cost principles applicable to environmental costs are FAR Subsections: 31.201-2, Allowability; 31.201-3, Reasonableness; and 31.201-4, Allocability. Other cost principles applicable in specific circumstances include FAR Subsections: 31.201-5, Credits; 31.205-3, Bad debts; 31.205-7, Contingencies; 31.205-15, Fines, penalties, and mischarging costs; and 31.205-47, Costs related to legal and other proceedings.

26-4 Normal Business Expense

Normal business expenses are those expenses that an ordinary, reasonable, prudent businessperson would incur in the course of conducting a competitive for-profit enterprise. In the context of environmental costs, normal business expenses are measured by the actual costs incurred in the period. Not all normal business expenses are allowable for Government contract costing purposes. To be allowable, costs must also be reasonable in amount, allocable to Government contracts, and not be specifically unallowable under Government cost principle provisions.

26-5 Reasonableness of Environmental Cost

The key concept for reasonableness of environmental costs (both preventive and remedial) is that the methods employed and the magnitude of the costs incurred must be consistent with the actions expected of an ordinary, reasonable, prudent businessperson performing non-government contracts in a competitive marketplace. A Government contractor should take measures to prevent or reduce contamination which a prudent businessperson would pursue to reduce its environmental costs.

Determination of reasonableness of clean-up costs also requires an examination of the circumstances of the contaminating events. Contractors should not be reimbursed for increased costs incurred in the clean-up of contamination which they should have avoided. In order to be allowable, contamination must have occurred despite due care to avoid the contamination, and despite the contractor's compliance with the law. Increased costs due to contractor delay in taking action after discovery of the contamination are not allowable. For forward pricing purposes, the costs should be net of reasonably available recoveries from insurance which would offset the clean-up costs.

26-6 Allocability of Environmental Cost

Costs incurred to prevent environmental contamination will generally be allocated as an indirect expense using a causal or beneficial base. Costs to clean up environmental contamination caused in prior years will generally be period costs allocated through a company's G&A expense pool. Clean-up costs incurred at a home-office, group-office, or other corporate-office level should be allocated to the segment(s) associated with the contamination for inclusion as part of the segment's G&A cost. Clean-up costs incurred by a segment should be allocated through its G&A expense pool if no other segments were associated with the contamination. If other segments participated in the contamination, a fair share of the clean-up costs should be allocated to the other segments for inclusion in their G&A expense pool. This is in accordance with CAS 403 and 410 for CAS-covered contractors.

26-7 Environmental Cost Related to Previous Sites and Closed Segments

If costs arise from a site the contractor segment previously occupied, the costs for clean-up would usually be allocated to the segment's site where the work was transferred. However, if the segment is closed with none of its former work remaining within the company, the cost would generally not be directly allocable to other segments of the business. There are many possible variations for the cost accounting treatment of environmental costs for a closed segment, depending on the facts of the particular situation. Information auditors should consider includes:

- Are any aspects of the closed segment's business being continued by the remaining segments?
- Is the site still owned by the contractor? If it is, what is its current use?
- If the site is not currently owned by the contractor, what were the terms of the sale in relation to environmental costs? The contractor may have retained environmental clean-up liability in exchange for a higher sale price or the buyer may have accepted full liability in exchange for a lower purchase price.

Each closed segment case must be reviewed based on its own facts to determine if the costs incurred for the closed segment should be directly allocated to

other segments, be allocated as residual home office costs, or be treated as an adjustment of costs associated with the closing of the segment.

26-8 Capitalization of Environmental Cost

Generally Accepted Accounting Principles as expressed in the Emerging Issues Task Force (EITF) Issue No. 90-8 indicate that environmental costs would normally be expensed in the period incurred unless the costs constitute a betterment or an improvement, or were for fixing up property held for sale. Betterments and improvements which exceed the contractor's capitalization threshold must be capitalized. Costs of fixing up a property for sale are generally considered to be part of the sales transaction, if realizable from the sale.

It would be unreasonable for the Government to accept as current period costs expenditures which increase the value of contractor assets; accordingly, these costs should be capitalized for Government contract costing purposes.

The EITF discusses the following situations where capitalization of the expenditures may be appropriate:

- Cost incurred to clean-up a site. These costs should be capitalized if the clean-up effort improves the property beyond the original condition of the property at acquisition. The costs incurred to restore a property to its acquisition condition are generally expensed unless they extend the property's useful life.

- Costs incurred to fix up property held for sale. These costs are to be capitalized, if they are realizable from the sale. A contractor may be required to incur contamination clean-up costs far in excess of any amount reasonably realizable upon sale. In the case of costs in excess of realizable costs, the excess amounts are expensed or capitalized depending on whether they improved the property beyond the property's condition at acquisition.

- Costs incurred to prevent future contamination. These costs would have an economic value in more than one period and should be amortized over their useful life. Capital assets purchased or constructed to prevent future contamination must be capitalized consistent with CAS 404 and GAAP.

Examples of capitalization of environmental costs:

- A contractor acquires property which was contaminated by a previous owner. Clean-up costs are capitalized as an improvement. Costs of ground and water clean-ups are increases to the book value of the land.

- A contractor cleans up contamination from its own operations since acquiring the property. If the property is being held for continuing use, the costs are expensed as period costs.

- A contractor incurs $80 million to clean up contamination it caused at a site which has a book value of $100 million and which is being held for sale at a price of $500 million. The $80 million is realizable from the sale and therefore, should be capitalized. If the sales price were $100 million instead, none of the $80 million would be realizable and it should be expensed in the period.

- The clean-up in example (3) is related to contamination existing at acquisition. In this situation, the $80 million would be capitalized even for the sale at a price of $100 million and would produce an $80 million loss on the sale. In effect, this would recognize that the contractor overpaid for the land at the time of acquisition.

26-9 Potentially Responsible Party (PRP) for Environmental Clean-Up

The environmental laws usually require each Potentially Responsible Party (PRP) for contamination at a site to be individually liable for the complete clean-up of the site. The allowable environmental cost should only include the contractor's share of the clean-up costs based on the actual percentage of the contamination attributable to the contractor.

Contractors with the ability to pay will be required to fund clean-up efforts for sites where they are named as PRPs. If the Government accepted contractor costs on an ability to make payment basis, a Government contractor could end up billing a disproportionate share of a site's clean-up costs to Government contracts instead of recovering the excess payments from other PRPs.

26-10 Environmental Bad Debts of Other PRPs

When a contractor pays for more than its share of the site clean-up, the contractor receives a right of contribution (or subrogation) against the other PRPs who did not make an appropriate contribution to the clean-up effort. If a contractor pays out more than its share of clean-up costs, it is up to that contractor to exercise its contribution rights to collect the amount over its share from the other PRPs who did not pay their share.

If a contractor cannot collect contribution or subrogation claims from other PRPs, the uncollected amounts are, in their essential nature, bad debts. Bad debts and associated collection costs, including legal fees, are unallowable costs (FAR 31.205-3 and 31.204(c)). However, see below for the exception to this guidance.

The guidance in the above two paragraphs does not apply in situations when all of the following three conditions are met:

- a contractor is legally required to pay another PRP's share of the clean-up costs;
- that PRP is out of business; and
- there is no successor company having assumed that PRP's liabilities.

When these three conditions are met, the clean-up costs which are attributable to the other PRP's contamination should not be disallowed as bad debt type expenses since there is no one against whom the contractor can take recovery action.

26-11 Insurance Recovery for Environmental Cost

The insurance industry does not currently consider environmental contamination an insurable risk (at a reasonable cost) in most circumstances. The major exception is a sudden accidental contamination, such as an oil tanker spill resulting from a collision. If such insurance is available and reasonably priced, its cost would be allowable.

Some courts have found that policies written before the insurance industry began to specifically exclude environmental coverage do afford coverage for environmental damages. Any insurance recoveries for a contamination clean-up will be applied as credits against any costs which were or would be otherwise allowable for that clean-up effort.

Many environmental contamination events now generating costs were insured, either under specific environmental impairment or comprehensive general liability coverages, before the insurance industry developed its current underwriting exclusions. It is the earlier insurance policies which are the source of the potential claims. Most insurance companies are contesting the claims and when payments are made, they are based on partial settlements or are made after lengthy legal battles. When a claim is possible and economically feasible, the contractor should pursue it.

The auditor should inquire about the existence of environment contamination policies and comprehensive general liability policies which do not contain environmental clean-up cost exclusions. The kind and amount of policies in effect from the time of the contamination to the current date are significant for the purposes of negotiating costs and prices for Government contracts.

The contractor's support for proposed clean-up costs should include a description of any insurance claim the contractor may have which could reduce the ultimate liability. The amount and timing of these claims for contract costing is a potential subject for negotiation which should be addressed by the auditor and ACO (see 26-15.).

26-12 Fault-Based Liabilities to Third Parties

Examples of liabilities to third parties include health impairment, property damage, or property devaluation for residents or property owners near a contaminated site. These third-party claims arise from legal theories of tort and trespass, and losses from such claims would be unreasonable in nature for payment on a Government contract. Such costs are not environmental costs.

In the absence of a specific court finding of tort or trespass by the contractor, the facts of each case should be carefully examined to determine if any contractor payments are nonetheless based on those or other fault-based legal theories.

26-13 Environmental Wrongdoing

If environmental clean-up costs are the result of contractor violation of laws, regulations, orders or permits, or disregard of warnings for potential contamination, the clean-up costs including any associated costs, such as legal costs, would be unreasonable and thus unallowable.

Fines or penalties are expressly unallowable under FAR 31.205-15 and any costs of legal proceedings where a fine or penalty could be imposed are covered by FAR 31.205-47. However, the incurrence of clean-up costs to correct environmental contamination is not a penalty; it is a legal obligation.

Most environmental laws do not require the contractor to be guilty of a violation to enforce contractor payment for clean-up costs. Therefore, it is rare for Government agencies to bring criminal, or even administrative, charges for contamination. Auditors should request the contractors to provide documents sufficient to allow a determination as to how the contamination occurred. The Environmental Protection Agency, in designating a company as a Potentially Responsible Party (PRP), will normally provide a written rationale as to how the company contributed to the contamination at a site.

For purposes of disallowing the costs, the Government must show that the preponderance of the evidence supports the position that the contractor violated the law, regulation, order or permit, or the contractor disregarded warnings for potential contamination. That is, it must be more likely that the Government's allegation of wrongdoing is correct than that it is not.

The contractor should not be denied recovery of clean-up costs, if it complied with the laws, regulations, and permits in effect at the time of the contamination.

26-14 Contingent Nature of Environmental Cost

Ideally, the Government wants to negotiate contract prices based on the net environmental costs after recovery of insurance claims and any amounts owed by later-discovered PRPs. At the time that environmental costs are being incurred, it may

not be possible to reasonably estimate what the net costs will ultimately be. Even where it is settled that a contractor will be required to clean up a prior contamination, it is rare that projections of the costs necessary to complete the project can be made with a reasonable degree of certainty.

Because of the uncertainty of the cost projections and of future recoveries from the insurance companies, as well as the difficulty in identifying all the other PRPs, both forecasted and incurred environmental clean-up costs and related legal costs that are allowable should be accepted contingent upon the Government participating in any insurance recoveries or the identification of other PRPs at a later date. See 26-15.

26-15 Advance Agreements for Environmental Cost

There are many areas of judgment involved in the determination of allowability for environmental costs. It is necessary for the auditor and the ACO to coordinate closely during the audit. Advance agreements should be considered to facilitate negotiations with the contractor.

Acceptance of the costs may require some form of agreement to protect the Government's interest. Any agreement to accept costs for clean-ups or for the costs of pursuing insurance recoveries should also provide expressly for Government participation in any insurance claim recoveries and any reductions resulting from later-discovered PRPs. Consideration should also be given to requiring contractor diligence in pursuing insurance recoveries and identifying contamination attributable to other PRPs. Advance agreements should provide for recovery of expenses priced into fixed price contracts if those expenses are later reduced based on subsequent identification of additional PRPs or insurance coverage after the agreement on price.

26-16 Environmental Clean-Up Trust Funds

Making payments for clean-up efforts through a trust fund is a device for the administrative and the financing convenience of the PRPs named at a given site. The allowability of costs on Government contracts should be based on the contractor's allocable share of the actual clean-up obligations. Contractor payments into a fund before clean-up costs are incurred are not an expense to the contractor until actual costs have been incurred for the site clean-up work. The excess or early payments are prepaid expenses.

It is the contractor's responsibility to support its claimed costs as allowable contract costs. Before accepting the contributions made to a trust fund as contract costs, auditors should obtain and evaluate sufficient supporting data to determine the allowability and the actual payment of the claimed costs. When the claimed "trust fund" costs are significant, the contractor should be requested, as part of its cost support, to arrange for Government audit access to the accounting records of the trust fund.