Advising your clients about environmental accounting issues

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The public accounting profession must become more proactive in their advice with respect to potential environmental problems and solutions

Introduction

A recent survey found that small business owners consider certified public accountants (CPAs) as the primary source of external advice concerning a variety of business situations[1]. CPAs were chosen by 44.5 per cent of the respondents as the most trusted external advisor, far ahead of other types of business consultants (20 per cent) or attorneys (18 per cent). CPAs provide counsel on many issues in cases where the business owners, management, or internal accounting staff may not have sufficient technical expertise. Both parties involved in this fiduciary relationship consider the long-term, stable nature of the arrangement extremely important. In the CPA's view, one of the primary elements of client service relates to issues imperative for the long-term survival and prosperity of the client.

One issue which has become of foremost concern is a firm's relationship with the natural environment. As the nation's awareness of the importance of the environment is heightened, firms are currently being held to a higher performance standard than in the past. Two aspects of this issue affect the operation of a business. First, mandatory compliance with federal and state legislation has resulted in numerous changes in the operations of many firms. The increasing regulatory burden has resulted in rising operating costs and, subsequently, lower earnings. A second matter is the disclosure and recognition of environmental contingencies and liabilities. While the compliance issue can result in increased costs, this second aspect can create considerable uncertainty about the long-term economic viability of clients.

Until recently, the accounting profession placed relatively little emphasis on recording or disclosing environmental liabilities and contingencies resulting from firm actions. Companies, with their auditors' concurrence, simply applied *Statement of Financial Accounting Standards No. 5: Accounting for Contingencies* (SFAS No. 5)[2], with most environmental liabilities being neither recorded nor disclosed. For example, according to the 1989 edition of *Accounting Trends and Techniques*[3], the financial statements of 128 of the 600 firms listed contained an environmental loss contingency. However, as the environmental issue has received more national attention, members of the accounting profession have begun to recognize the magnitude of the possible highly negative effects on the financial well-being of firms and, consequently, the need to better disclose or accrue the contingencies. By 1993, 233 of the 600 firms listed in *Accounting Trends and Techniques*[4] disclosed environmental contingencies.

This same awareness can also affect smaller firms. These firms are especially vulnerable given their relatively smaller asset base and earnings potential. Smaller firms may not have the financial capability to adopt environmentally sound manufacturing and disposal processes. This lack of proactive response due to limited resources and a lack of technical sophistication can lead to costly clean-up obligations. Such a large environmental liability could effectively shut down a smaller firm whereas a large firm (such as Exxon and the Valdez incident) can absorb the potential costs.

Smaller firms are also limited in terms of internal expertise in dealing with complex environmental regulations which are constantly changing. There may be no in-house compliance person, thus exposing the firm to more potential liability. In addition, smaller firms may not have the resources to hire external experts to assess their operations with regard to handling, transporting and disposing of hazardous waste.

In summary, the issues involved in the environmental area are even more pronounced when faced by smaller firms. As trusted advisers to small firms, CPAs must step forward and begin to inform their clients better of the problems and solutions. Only by doing this can the long-term survival and profitability of many clients be ensured.

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Inconsistent practices

The primary pronouncement used in accounting for environmental contingencies is SFAS No. 5[2]. Most authorities on environmental accounting agree that this Statement, issued in 1975, was never intended to be used in this manner. However, the lack of additional guidelines by the Financial Accounting Standards Board (FASB) has necessitated its use. Numerous articles have been written detailing the accounting issues and therefore the specific treatments will not be discussed[5-7].

Three major areas of concern permeate the entire environmental accounting issue – the timing of the disclosure, quantifying the estimate of the liability and the Income Statement presentation of clean-up costs. To assess these problem areas, a survey was conducted by the authors of 940 CPA firms in the southeast region of the United States. A total of 150 firms responded representing a cross-section of local, regional and national public accounting firms.

Timing of disclosure

The timing of the disclosure of a potential environmental liability is critical to the potential users of the accounting information. Users should be informed of the existence of a contingent expense and potentially sizeable cash outflow as soon as the criteria of SFAS No. 5 are met. An improperly delayed disclosure would undermine the reliability and timeliness of the financial information and lead to less efficient user decisions. Alternatively, premature disclosure could lead to a unwarranted devaluation of the company. If the firm is publicly held, the message sent to stockholders may also reverberate throughout the financial community and hinder the firm's ability to raise capital. Privately held firms could be severely damaged by such large potential expenditures due to their inability to raise adequate capital.

In the survey of CPA firms, CPA opinions about the timing of disclosing a potential environmental liability in the financial statements revealed an overall lack of consistency among practitioners. Thirty-seven per cent of the respondents reported that disclosure should be made when SFAS No. 5 liability is probable but not yet estimable, and 32 per cent believed that disclosure is required when the liability becomes reasonably possible. Under SFAS No. 5, both of these situations require disclosure. The survey results highlight two areas of concern: the 31 per cent of the respondents who did not know the proper SFAS No. 5 disclosure treatment and chose an improper treatment in the survey; and no respondent marked both categories in the survey.

Measurement issues

The measurement of the potential liability is often very difficult to quantify. Factors such as the cost of the preferred clean-up method (which can change with even newer EPA regulations), the availability of insurance reimbursement, the financial viability and contributions of co-parties, and the length of time for clean-up activities have proven to make an accurate measurement of the future liability difficult. These realities place a great burden on the accountant who must estimate, with some degree of accuracy, the amount of the potential liability which is the determining factor in the accounting treatment of the environmental liability (disclosure versus accrual).

This measurement concern is supported by the survey results which reveal the difficulties practitioners face when advising clients about potential environmental liabilities. When determining the amount of the estimated liability, none of the factors discussed was ranked significantly different from the others. The respondents' views about the importance of various variables in the estimation process are inconsistent, with no one factor being clearly preferred by practitioners to help in this complicated process. To complicate the issue further, no specific authoritative support has been issued to assist the practitioner.

Income statement presentation

Uncertainty exists as to the proper Income Statement presentation of environmental clean-up costs when they are incurred. Treatment as an ordinary operating expense was considered appropriate by 42.9 per cent of the respondents, extraordinary expense recognition by 35.4 per cent and non-operating expense by 17.7 per cent. These varying opinions of practitioners concerning this item demonstrate that consistent treatment has not been achieved.

Future actions

These inconsistent practices shown by the survey results are mainly due to the lack of authoritative support in the area. The deficiencies of SFAS No. 5 are recognized by members of the accounting profession. Dennis Beresford, Chairman of the FASB, has indicated that SFAS No. 5 may not be adequate to allow for the proper financial statement presentation of environmental contingencies. According to Beresford, "Another issue that may receive greater attention is accounting for environmental matters"[8]. Continuing, Beresford adds that application of SFAS No. 5 "is not providing the right answer when it comes to environmental matters because the loss may not be absolutely probable or it is not possible to make a reasonable estimate".

To date, the FASB has not tackled the problem associated with environmental liabilities. Given the deficiencies of SFAS No. 5, the views of the FASB chairman, the perceived magnitude of the problem, the national awareness of the environment and the inconsistent practices which have evolved, the FASB will be forced to deal with the issues involved in the environmental area. In fact, adding the issue to the Board's agenda was considered in 1994[9]. When the FASB does address environmental liabilities, the Board will almost certainly require more rigorous recording of these liabilities. The Board has shown by past actions (SFAS Nos. 87[10], 106[11], 109[12], etc.) a desire to increase the balance sheet recognition of liabilities. Firms will be required to adopt the more stringent pronouncements, thus directly affecting the firm's financial statements. As primary outside advisers to clients, CPAs must alert clients with potential problems to this developing trend.

Impact on firm management and strategic planning

As the primary external advisor to a firm, the CPA must be aware of three critical issues that can adversely affect clients' operations. Management decisions and long-term planning can be affected in the areas of valuation of the business, divestiture and acquisition, and access to capital.

Valuation of the business

More stringent accounting treatments regarding the measurement and disclosure of environmental contingencies will directly and, in most cases, adversely affect the value of the firm. Because these liabilities remain on the balance sheet until a full and complete clean-up has occurred, which may take years, the value of the firm can be negatively affected for the long-term horizon.

Acquisition and divestiture

The firm facing environmental liabilities should also be advised about the impact these liabilities may have on acquisition and divestiture activities. Acquisition of firms or firm segments with an identified environmental problem may create significant problems for the acquirer. The acquiring firm may find it impossible to justify to its stockholders the long-term financial risk that they would legally be assuming by acquiring a firm already identified as "at risk". By EPA rules, the current owner has the same liability for the clean-up as the original polluter.

The divestiture of a firm that has been identified as having an environmental problem becomes extremely complicated and potentially impossible. As discussed earlier, the value of the firm will probably be depressed because of the risk of the potential long-term expenses or liabilities from an environmental problem. The owner may not be able to find a buyer willing to pay a reasonable price that allows divestiture in a timely manner. In reality, the potential environmental liability may result in buyers avoiding the firm entirely and searching for an acquisition not burdened by an environmental problem. Thus, business owners may find that a "cash out" strategy is not a viable option.

Access to capital

A third major area of concern for the CPA acting as an external business advisor is the client's access to capital. Because of the unsettled nature of the issue, many in the banking profession are hesitant to make loans to certain types of firms. Financial institutions evaluating the potential borrower's balance sheet may find that the environmental liability "landmine" produces financial ratios that are not acceptable. The issue of a secured lender's potential liability for the environmental clean-up of collaterized property will almost definitely reduce a bank's willingness to lend. There is uncertainty within the legal system since some courts have found the bank liable in some instances yet not liable in other instances with similar circumstances.

The net result is that working capital may be more difficult to obtain, not to mention the capital normally needed for expansion and growth. In a period of time when the economy needs the manufacturing sector to create permanent, high-paying jobs, bank lending could be further restricted due to the bank's evaluation of the environmental risk. Banks are historically conservative lenders and any existence of a potential liability will be met by either a rejection of the loan or pricing the risk with a higher cost of borrowing.

Equity capital may be equally difficult to attract due to the investor's unwillingness to choose a firm "at risk" over one that is risk free of environmental problems. Equity investment dollars will logically flow away from the more risk-prone alternatives towards those which are considered safer.

The CPA's role as external advisor

The CPA must take a proactive stance in this area. Several of the audit procedures listed above involve discussion with management about the potential for major problems confronting the client if the issue is not properly handled. The CPA must stress to his/her clients that immediate action is necessary to ensure that they do not face an uncertain operating future. Also, the CPA must counsel the client to examine past actions, even those that may have occurred before current management was employed. The fact that past actions are as potentially damaging as current activities should be stressed to the client.

Financial accounting standards are in the process of undergoing significant changes with respect to the recognition of environmental liabilities. These changes can, and should be, anticipated by CPAs. As respected advisers to clients, CPAs must make their clients aware of the impacts of new accounting standards on the treatment of environmental liabilities.

The survey data collected by the authors clearly reports that there is little consistency among CPAs on their interpretation and application of existing financial reporting standards, and subsequently, on the advice provided to their clients.

Recent audit risk alerts help to clarify the areas where the CPA should examine the client's operations to identify potential environmental liabilities properly. The suggested audit procedures can be implemented and hopefully serve to provide the client with adequate warning of their potential liability. No client wants to receive this type of negative information, yet the CPA adviser must be prepared to assess the situation objectively and to inform their clients of the potential magnitude of any problem.

Three factors make self-assessment and immediate action on the part of firms beneficial. First, the Internal Revenue Service now allows firms to treat clean-up expenses as "ordinary and necessary business expenses" and thus take an immediate tax deduction for these costs [13]. Second, research has shown that firms which perform clean-up operations before the involvement of a government agency have a lower total clean-up cost[7]. Third, identifying and considering possible environmental concerns before required adoption of more stringent accounting standards can reduce the future impact of tougher financial accounting standards on the financial statements of clients. Firms which take a proactive approach to the environmental area can reduce future uncertainty and avoid the problems associated with valuation, divestiture and acquisition, and access to capital.

The issues are real, present, and potentially devastating to small- and medium-size firms involved in all types of operations. Manufacturers are especially vulnerable, but service firms such as dry-cleaners can find themselves facing a large clean-up expense. The public accounting profession must step forward and begin, on behalf of their clients, to determine the scope of the potential liabilities and advise both their clients and public policy makers on the implications of this dilemma. The profession is grounded in the public trust, and events in the past few decades (especially the savings and loan crisis) should have taught the profession the value of being proactive rather than reactive to issues with such far-reaching implications.

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