COMPANIES GRAPPLE TO QUANTIFY ASSET RETIREMENT OBLIGATIONS

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A review of recent public reporting disclosures, submitted by companies in an attempt to comply with a financial accounting interpretation issued last year, suggests that substantial confusion exists in the marketplace. Under applicable accounting principles, a company is to accrue the costs associated with an asset retirement during the life of the asset. Financial Accounting Standard 143 says so, and it has been around for a number of years. Even so, most publicly traded companies failed to comply, contending that uncertainty as to the timing of the asset retirement, or uncertainty in the cost of the retirement obligation, precluded them from quantifying the liability. In response, the Financial Accounting Standards Board issued Financial Interpretation 47 (FIN 47). That interpretation, in a nut-shell, requires companies to report liabilities now, with uncertainty as to timing or amount to be built into the estimate of the obligation.

The triggering date for application of the new interpretation starts with fiscal years ending in December 2006, so companies that have begun implementing the new methodology have begun to take accounting charges for the cumulative effect of the change in accounting principle. Rockwell Automation just took an $18.1 million after-tax charge related to the adoption of FIN 47. Johnson Controls recorded a non-cash, after-tax charge of $7 million. Some utilities have recorded charges in excess of $200 million. Tammy Whitehouse, a reporter with *Compliance Week* (Aug. 29, 2006), analyzed the disclosures of many companies to determine if similarly situated companies were responding in the same fashion. The reporter concluded that they were not; in fact, the results were “wildly disparate.”

No doubt, there are many aspects of FIN 47 that breed confusion. One vexing aspect of FIN 47 that concerns most companies is determining whether FAS 143 and FIN 47 require them to investigate existing property to determine if it is contaminated and what it might cost to clean up. Land typically has an indeterminate life, so no asset retirement obligation may exist. On the other hand, if a company anticipates that it will be selling the real estate at some point in the future, then the requirements of FAS 143 could trigger because the sale constitutes a "retirement" of the asset. Another issue that companies face is determining whether the asset retirement obligation has arisen from "normal" operations. If so, FAS 143 applies; if not, it doesn't. What does the company do regarding spills and leaks that cause contamination? In some situations, the spills and leaks might be considered to be normal; on the other hand, a catastrophic event causing a major spill probably should not be accounted for under FAS 143, although it might need to be addressed under other accounting standards.

The fact that similarly situated companies might view their reporting obligations differently is no surprise given that judgment from a multi-disciplinary team – melding legal, environmental, engineering, and accounting talent – is needed to assess how to apply the standard. With so many players bringing diverse backgrounds and perspectives into the evaluation, it is not surprising to see a lack of consistency in the application of FIN 47, particularly so in its early stages of adoption.

While there may be confusion among those who have already reported, there likely is a far larger number of companies that are completely unaware of FIN 47 and its application,

particularly outside of heavily-regulated industries such as utilities and mining companies that are laden with asset-retirement obligations (AROs). Many companies have not considered what legal obligations attach to their asset retirement while others likely have not adequately performed this analysis. Ask a client about it and don't be surprised to get a blank stare in return. Executives, by and large, are simply unaware of what this could mean to their company, and instead view it as something to leave to the accountants. But accountants can not make these determinations alone, because accountants generally do not understand the long term asset retirement obligations that may exist for companies other than obvious ones like nuclear power plants or mining operations, with decommissioning and reclamation costs, respectively. Moreover, even professionals within the organization who are expected to understand the company's regulatory and environmental compliance obligations may not have the information needed to evaluate <u>these</u> liabilities. Future "closure obligations" typically are not included in environmental audits, either those performed in connection with the purchase of an asset, or those periodic "operational audits" performed to measure and maintain environmental and OSHA compliance.

FIN 47 mandates that a company recognize the fair value of the liability it possesses for cleanup costs associated with future plant closure, such as the presence of asbestos in a building or factory. Yet FIN 47 also extends beyond plant closure, and attaches to any asset retirement activity - even if that activity can be deferred indefinitely - so long as an existing law, regulation or contract requires an entity to perform the activity upon retirement of the asset. For example, a telecommunications entity whose communication network uses wood poles treated with certain chemicals has certain legal obligations regarding the disposal of the poles once removed from the ground. Although the company is under no legal obligation to remove the poles, it has sufficient experience to determine its replacement frequency, or in the words of the Interpretation, "the entity has information to estimate a range of potential settlement dates, the potential methods of settlement, and the probabilities associated with the potential settlement dates and methods… [and] is able to estimate the fair value of the liability for the required disposal procedures using an expected present value technique." Removal of Underground Storage Tanks and closure obligations associated with hazardous waste treatment, storage or disposal units under the Resource Conservation and Recovery Act (RCRA) are obvious examples of AROs.

Once the legal obligations attaching to retirement of an asset are properly identified, the company's FAS 143 analysis will shift to whether the entity has sufficient information to reasonably estimate the fair value of the asset retirement obligation. Many companies express discomfort with this process, particularly for obligations that depend upon regulatory input in determining ultimately what will be required. The lament is that one cannot reasonably estimate the future cost if one has little or, no, idea of what the regulator will require. Even so, under FAS 143, uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation does not excuse the need to quantify and report the liability. Instead, uncertainty is factored into the "fair value" measurement of the liability. The practical effect is that a company will need to obtain a better estimate of the closure costs it is likely to face, and then price those obligations using present value techniques, or other methods of valuation (for example if an active market exists for the transfer of the obligation). For more guidance on what constitutes fair value, see

Statement of Financial Accounting Standards No. 157 (Sept. 2006)

Under FAS 143, where the information simply is insufficient to estimate the fair value of the asset, the company must still identify the ARO and explain why insufficient information exists. For example, if an asset has an indeterminate useful life, sufficient information to estimate a range of potential settlement dates for the obligation might not be immediately available. In such cases, the liability would be initially recognized in the period in which sufficient information becomes available. As such, even where the liability presently cannot be reasonably estimated, the company will need a mechanism that tracks the liability over time and the company's future plans as they might affect that asset, so that the liability can be timely recognized once sufficient information becomes available.

Compliance with FAS 143 and FIN 47 presents a pitfall for the uninformed. The SEC is concerned with proper reporting of environmental obligations, and shareholder suits for inadequate and improper reporting are in vogue. It is a classic case of a client not realizing the magnitude of risk presented by a seemingly routine task typically handled at a relatively low level of responsibility within the company. Ask your client what he is doing to accurately report and quantify asset retirement obligations. Then, assemble a qualified team to aid in the evaluation. That's the type of value-added service your client expects, and deserves.

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