

**The Institute of  
Chartered Accountants**  
In England & Wales



# **ENVIRONMENTAL ISSUES IN FINANCIAL REPORTING**

**October 1996**

# ENVIRONMENTAL ISSUES IN FINANCIAL REPORTING

## *Introduction*

1. In April 1995, a discussion paper on the financial reporting of environmental costs, liabilities and impaired assets was issued by a working party of the ICAEW Environment Steering Group (FRAG 12/95). Over 50 letters of comment were received from a wide range of representative bodies, accountancy firms, companies and individuals. Whilst there was some concern about its timing and the need to identify environmental costs as a separate issue, the discussion paper was well received by the majority of respondents who expressed an opinion.
2. In the period that has elapsed since the publication of the ICAEW discussion paper, there have been four significant developments of relevance to the subject:
  - In November 1995, the Accounting Standards Board (ASB) issued a discussion paper on provisions, including a separate section dealing with environmental liabilities.
  - The EC Accounting Advisory Forum concluded its discussion, in December 1995, of a draft document 'Environmental issues in financial reporting' (the working document for the Forum). This has now been published.
  - A consultation paper 'Environmental reporting and the financial sector' was issued in April 1996 by the Advisory Committee on Business and the Environment (ACBE), setting out draft guidelines of good practice.
  - Also in April 1996, the ASB issued a discussion paper on the impairment of tangible fixed assets, with environmental impairment quoted as examples.

Whilst none of these papers are mandatory, they indicate the growing importance of environmental issues in financial reporting

3. The present paper is therefore intended as a follow up to the ICAEW's previous initiative, building on the comments received and the subsequent discussion, as well as the other documents that have been issued. In a number of cases, we have considered and rejected the points that were made and, where appropriate, our reasons for doing so are set out in this paper. We have also reviewed the responses to questions relating to environmental liabilities in the ASB discussion paper on provisions and where appropriate, our comments address some of the concerns that were raised.
4. As we postulated in the discussion paper, the treatment on environmental issues in financial reporting is largely an application of the existing framework and accounting standards are generally adequate to enable environmental liabilities to be properly accounted for in financial statements. In some cases, such as accounting for provisions, the standard is still taking shape and the ASB expects to issue an exposure draft in 1997. This paper is therefore intended as a contribution to the ongoing debate. We recognise that it will be for the ASB to set any mandatory requirements but, in the meantime, we believe there are issues that need to be aired amongst members of this Institute as well as others with an interest in the subject.
5. We consider that, in broad terms, there are three main audiences for the paper. Firstly, to update the ASB with a progress report on our views, following the consultation on FRAG 12/95. Secondly, to help preparers in dealing with environmental issues where no formal guidance is yet available. Thirdly, to influence opinion formers who may believe that financial reporting requirements are not capable of dealing with environmental issues. The paper has possible implications for all entities for which environmental considerations are significant and is not directed solely at large companies.
6. The paper seeks to address a number of issues relevant of financial reporting that were not covered by our previous discussion paper but were raised by respondents. Consequently, its scope is not limited to environmental liabilities. The paper does not set out to promote enhanced environmental reporting, desirable though this may be, nor does it address the question of whether users of financial statements should be given more information about the entity's exposure to risks, including those of an environmental nature. The paper is confined to matters of concern to the preparer of financial statements and does not address audit considerations.

7. The issues are dealt with under the following headings:

- I. Environmental costs
- II. Accounting of environmental costs
- III. Accounting for environmental liabilities
- IV. Contingent environmental liabilities
- V. Impairment of assets
- VI. Disclosure
- VII. Conclusions

In analysing the issues, the paper suggests an appropriate way forward but does not set out to provide a formal interpretation of existing requirements in order to deal with environmental issues.

8. If a reader wishes to make any particular observations, we would be pleased to receive these and, unless the commentator requests confidentiality, we propose to pass a copy to the ASB and place the response on public record. Comments should be addressed to:

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## EXECUTIVE SUMMARY

### *Introduction*

This paper has been produced by a working party set up by the Institute's Environment Steering Group. We see the paper as a contribution to the debate, which is likely to increase with public concerns about the environment. It builds on a ICAEW discussion paper on the financial reporting of environmental liabilities issued in April 1995 and reflects some of the thinking in the Accounting Standards Board's recent discussion paper on provisions. In doing so, the paper deals with such topics as the recognition and measurement of environmental liabilities, the impact of new laws and technology and the question of whether environmental costs should be recorded as an asset.

In preparing the paper, the working party has taken account of developments taking place elsewhere. In the UK, the topic of environmental liabilities is beginning to be addressed by the ASB. A code of practice on environment reporting has been developed by the Advisory Committee on Business and the Environment. In Europe, the accountancy bodies are discussing matters of common concern in the area of environmental accounting and reporting. There is also considerable interest in the subject in the US and in Canada.

### *Scope*

The paper addresses such questions as:

- Should environmental costs be distinguished from other costs and, if so, how?
- When should environmental costs be capitalised rather than being charged direct to the profit and loss account?
- At what point should environmental liabilities be recognised?
- How should the measurement problems be approached?
- What is the appropriate treatment for assets that are impaired due to environmental factors?
- Should financial statements provide additional information where environmental issues are of significance?

The paper does not attempt to deal with external costs arising from the impact of the business on the environment, such as the use of air and soil or the emission of waste gasses. These topics fall within the role of the environmental reports which are often designed for a different audience and recognise that many users will have special needs.

## *Conclusions*

Whilst there is a perception amongst some people that financial reporting frameworks do not readily deal with environmental liabilities, the working party found that the existing framework was adequate, recognising that environmental issues present certain difficulties in terms of quantification and the timing of recognition.

The working party's conclusions may be summarised as follows:

- Provision should be made for all environmental liabilities for which there is an obligation, unless a reasonable estimate of the obligation cannot be made.
- An environmental liability should be measured, as the estimate amount of future cash flows required to settle the obligation, discounting the amount where this has a material effect.
- Expected recoveries from third parties should be estimated separately and should not normally be offset against the environmental liability.
- Environmental costs should be recognised as soon as an entity has an obligation.
- Environmental costs that provide access to future economic benefits, including the continued operation of an asset, should be capitalised.
- Environmental impairment of an asset should be recognised by reducing its carrying value to reflect its current value.
- Financial statements should describe the accounting policies relating to any significant environmental costs and liabilities that are disclosed.
- Inclusion of a management commentary on any material environmental issues affecting, or likely to affect, the enterprise should be regarded as good practice for all entities.

There will be considerable advantages in achieving an international consensus on the financial reporting of environmental issues. Whilst the principles being proposed or adopted by standard setters for the recognition of provisions generally are fairly rigid, in that there has to be an obligation which the entity cannot avoid for such a provision to be established, the uncertainties relating to many environmental liabilities make interpretation difficult and this paper aims to provide additional guidance.

## ***I. ENVIRONMENTAL COSTS***

### ***The nature of environmental costs***

- 1.1. Environmental costs, like other costs, are rarely disclosed separately unless they form an exceptional item. In this paper, we are therefore concerned with the application of generally accepted accounting principles to environmental costs and the need to ensure consistent treatment where such costs are disclosed voluntarily.
- 1.2. In reporting on environmental issues, it is usual to think of the impact or potential impact of an entity on the environment. However, because of the way a business operates and because its market share depends on upon its reputation and, ultimately, its licence to operate, the environment has a corresponding impact on the business. The two aspects should not be confused, although sensible environmental management benefits both aspects. This paper is concerned with the financial impacts of environmental issues on a business and the way in which they may need to be reflected in its financial statements. It does not address the external costs arising from the impact of business operations on the environment; this is normally part of the role of environmental reporting.
- 1.3. Environmental costs arise in a number of ways. For example, there may be an obligation to operate a production site to a prescribed standard, contaminated land may need to be rectified, or emissions from an industrial plant may have to be reduced. From an accounting perspective, there is generally no reason to treat environmental costs in a different way from other costs.
- 1.4. Environmental impacts are often indistinguishable from other impacts as they are managed together and the cost relating to an environmental benefit may be impossible to identify. For example, using different materials so as to minimise waste may also reduce disposal costs; investment in increased energy efficiency also reduces energy costs.

### ***Definitions***

- 1.5 The definition set out below are based on those in a CICA research report<sup>1</sup>.

“Environmental costs” include:

- (i) the costs of environmental measures; and
- (ii) environmental losses.

“Environmental measures” are steps taken by an entity or, on its behalf, by others, to prevent, reduce or repair damage to the environment or to deal with the conservation of resources.

“Environmental losses” are cost incurred by an entity in relation to the environment for which there is no return or benefits, for example.

- (i) assets whose cost are irrecoverable due to environmental concerns;
- (ii) damages paid to other for environmental damages; or
- (iii) fines or penalties for non-compliance with environmental regulations.

We believe that these definitions remain an appropriate starting point.

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<sup>1</sup> “Environmental costs and liabilities: Accounting and financial reporting issues”, a research report published by the Canadian Institute of Chartered Accountants in 1993. A statement of principles has recently been developed which may form the basis for a new CICA accounting standard.

- 1.6. Environmental costs do not include costs that relate to product and process safety. Product safety involves measures to ensure the safe use of products. Process safety involves measures to reduce risks to employees engaged in the process. Some entities operate a combined safety, health and environmental management system, however, and may find it difficult to distinguish environmental costs from those relating to health and safety. Where this is the case and environment costs are disclosed it is helpful to explain that separate information is not available as a combined management system is in use.

### ***Comprehensive allocation of costs versus a “wholly and exclusively” approach***

- 1.7. Costs of environmental measures are sometimes difficult to distinguish. The ICAEW discussion paper took a broadly neutral position between making a comprehensive allocation of costs so as to arrive at the cost of environmental measures and only including those costs that are “wholly and exclusively” attributable to environmental measures. Any disclosures about such costs should be as complete as possible, subject to the technical constraints of quantification. Where an entity wishes to make a comprehensive allocation of costs, this should be regarded as an acceptable practice, provided that a rational approach is adopted and the basis of allocation is described.
- 1.8. There is an argument that environmental costs should be confined to those which relate “wholly and exclusively” to preventing, reducing or repairing damage to the environment and should exclude, for example, costs incurred so as to conserve energy, and closure costs, even if the closure takes place for environmental reasons. As a basis for comparison, a “wholly and exclusively” condition may offer the most satisfactory approach. However, to avoid misleading a user of the accounts due to the possible overlap with other costs and benefits, it is important that there is adequate disclosure of what environmental costs include or, in some cases, exclude.
- 1.9. Expenditure will often have a dual purpose as the management of environmental impacts is integrated with general management. Thus capital expenditure, for example the renewal of a plant incorporating the latest technology or the refitting of an existing plant, will often be incurred primarily to provide improved production efficiency; better environmental performance may follow as a secondary consideration. Isolating the element of expenditure relating to environment benefits is therefore difficult. In any event, capital expenditure planning would normally be carried out on an integrated basis.
- 1.10. A judgemental allocation of costs, based on the best information available and including, where appropriate, an engineering assessment, may nevertheless need to be made if a separate figure is required. For instance, discussion of capital expenditure in the operating and financial review (OFR) may include information about the amount spent on environmental protection. Otherwise, even in the case of capital expenditure projects which are carried out primarily for environment reasons, a “wholly and exclusively” approach would normally be appropriate.

### ***Compliance costs, fines and penalties***

- 1.11. Unless they form an exceptional item, the costs of complying with regulations of any nature do not require to be disclosed and it could be misleading for the costs of complying with environment regulations to be given particular prominence. In any event, it may be difficult for a business to identify such costs as a separate item.
- 1.12. Several respondents to the ICAEW discussion paper suggested that entities should be required to confirm that they comply with environmental regulations. This would be particularly complex in a multinational situation, because of the different regulations involved. It also operates against the principle of reporting positively on matters that are material or exceptional,

rather than confirming compliance in one particular area of the law. Reporting any significant non-compliance is therefore more important.

- 1.13. Other respondents argued that there should be a more specific requirement to disclose and discuss the impact of changes in environmental laws and regulations that may have a significant effect on the business. The Companies Act Sch 7 para 6(b) already requires a directors' report to contain an indication of likely future developments in the business although the requirements is not amplified in any way. The ASB statement on the content of an OFR also recommends that directors of listed companies and public interest corporations should discuss events expected to have an impact on the business in the future. It is desirable that such discussion should include any significant environmental issues such as the cost of dealing with environmental liabilities. The inclusion of an OFR within the annual report should be adopted more widely as "good practice".
- 1.14 Some entities provide information about their environmental management system EMS so as to assure customers and shareholders that compliance with the regulations is being achieved and that environmental risks are being effectively managed, or that programmes are being undertaken to reach these objectives. This form of reporting may be an effective way of meeting the concerns of users. However, it is a matter that needs to be addressed separately, possibly in connection with corporate governance. It would also be reasonable to include health and safety issues, as companies often allocate responsibility for health, safety and environmental management to the same committee of the board that deals with corporate governance.
- 1.15 The working document<sup>2</sup> for the Forum excludes from the definition of environmental expenditure "costs incurred as a result of fines or penalties for non-compliance with environmental regulations, compensation to third parties as a result of loss or injury caused by past environmental pollution and similar environmentally related costs". This distinction may be difficult to sustain as costs of this nature need to be taken into account in any assessment of environmental performance.

### ***Public sector and the role of regulatory bodies***

- 1.16 There was a comment that the ICAEW discussion paper did not address the environmental problems in the public services or the role of regulatory bodies in defining and classifying environmental liabilities for pollution costs. In principle, the financial reporting issues confronting public services are not significantly different from those in the private sector. This is not to understate the problems, particularly as regards auditing financial statements in the public sector that include environmental liabilities. There is also the possibility that timescale will be longer, and uncertainties and potential costs very much greater. The principles, however, are essentially the same.
- 1.17 The recognition and measurement of liabilities may also be influenced, in both the private sector and the public sector, by the role of regulatory bodies. In the UK, such bodies are currently undergoing significant changes. This may add to the uncertainty involved in the determination of liabilities, particularly in relation to contaminated land.

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<sup>2</sup> Working document for the EC Accounting Advisory Forum "Environmental Issues in Financial Reporting".

## ***II ACCOUNTING FOR ENVIRONMENTAL COSTS***

### ***Issues to be considered***

- 2.1 As stated in paragraph 1.1 above, environmental costs are rarely disclosed separately, unless they represent an exceptional item, and there is generally no reason to treat environmental costs in a different way from other costs. For example, the environmental costs should be recognised as soon as the entity has an obligation. The accounting issues are therefore largely confined to the treatment of environmental costs identified in the current year but relating to prior years and whether environmental costs should be capitalised or charged to profit and loss account as they are incurred.

### ***Environmental costs to be expensed***

- 2.2 The ICAEW discussion paper proposed that material environmental costs that relate to continuing activities or to discontinued activities should be charged in arriving at the profit or loss on ordinary activities and that costs relating to prior years should be shown separately from costs relating to current activities. Environmental losses, for which there is no return or benefit, should always be charged to the profit and loss account. It was also noted that:
- FRS3 “Reporting financial performance” may require environmental costs to be reported separately as an exceptional item if additional disclosure is necessary to show a true and fair view.
  - The cost of assets used for the clean up of past environment damage should be treated in the same way as other costs related to the clean up.
  - A fine or penalty that relates to past operating activities should be treated as a current period item.
- 2.3 FRS3 would generally prevent environmental costs being treated as a prior year adjustment except where there is a change in accounting policy or where there was a fundamental error in estimating such costs in a prior period. However, costs relating to past activities may need to be shown separately in presenting an analysis of segment result.
- 2.4 In the case of a provision for environmental liabilities in an acquired entity, provisions is made as at the date of acquisition. Where those environmental costs pre-dated the acquisition and were not covered by an indemnity or warranty, FRS7 “Fair values in acquisition accounting” requires that the fair values of the acquired entity should be adjusted so as to provide for the costs involved. In other cases, the costs should be accounted for as post-acquisition expenses of the newly combined entity.
- 2.5 The working document for the Forum states that environmental expenditures are normally expenses in the current period and that, where such expenditures are incurred to clean up past environmental damages, they should be regarded as maintenance or repair costs.

### ***Criteria for capitalisation***

- 2.6 The ICAEW discussion paper envisaged that environmental costs that can be directly associated with the future economic benefits of identifiable assets should normally be capitalised as part of the cost of the asset. Such costs would be limited to those incurred during the construction or development of a capital asset, to alleviate future damage to the environment arising from the asset, or to conserve natural resources consumed by the asset. Such costs should be amortised over a period not exceeding the estimated useful life of the related asset and included with any other environmental costs that are disclosed.

- 2.7 The ASB discussion paper on provisions proposes that provisions for environmental expenditure should be capitalised when, and only when, the expenditure provides access to future economic benefits; in other cases, the provision should be charged immediately as an expenses.
- 2.8 A number of respondents to the ASB discussion paper suggested that provisions for environmental expenditure required on the closure or abandonment of an asset should be built up over the useful life of the related asset and charged to the profit and loss account rather than being provided for at the outset and capitalised. The effect on the profit and loss account would of course be the same. Another comment was that a distinction should be made between expenditure incurred to clean up past contamination, which should be charged to the profit and loss account, and expenditure to eliminate future contamination, which should be capitalised.
- 2.9 The ICAEW discussion paper took the view that capitalisation should be based on the 'increased future benefits' approach, with 'benefits' being interpreted reasonably widely so as to include the continued operation of an asset. The ASB has adopted the criterion of access to future economic benefits, rather than increased future economic benefits. This approach dispenses with the need to demonstrate an increase in economic benefits; for example, expenditure that is necessary to maintain an operating licence so as to continue operations, or to avoid closure, could qualify for capitalisation.
- 2.10 It should be noted that, in certain circumstances, the amount of environmental costs will be very large, with the result that their inclusion on the balance sheet will have a very dramatic effect. This is not likely to cause a problem provided users of financial statements understand the nature of the issue and the accounting treatment adopted. Adequate disclosure will therefore be important.
- 2.11 Where an environmental cost meets the criteria for recognition as an asset and is directly related to another capital asset, it should be included as part of the cost of that asset and not recognised separately. A test for impairment should be carried out to ensure that capitalisation does not occur if the expected future benefits arising from the asset, or groups of assets, after incurring the expenditure, fall short of the increased total costs. General rules for such impairment tests are proposed in the ASB discussion paper on impairment of tangible fixed assets, which would also apply to environmental impairment. The procedure for determining the recoverable amount would normally be based on expected future cash flow.
- 2.12 The question may arise as to how to deal with environmental expenditure which is not related to an asset that is capitalised, such as land held on a short lease. Such expenditure should be treated in the same way as any other environmental cost; that is, it should be provided for at the point of obligation and capitalised if the appropriate criteria are met.
- 2.13 Where environmental expenditures are incurred to prevent or reduce future environmental damage or to conserve resources, the working document for the forum states that they may qualify for recognition as an asset if they are intended for use on a continuing basis for the purpose of the undertaking's activities and if, in addition, one of the following criteria is met:
- (a) The costs relate to anticipated environmental benefits and extend the life, increase the capacity, or improve the safety or efficiency of asset owned by the company; or
  - (b) The costs reduce or prevent environmental contamination that is likely to occur as a result of future operations.

### **III ACCOUNTING FOR ENVIRONMENTAL LIABILITIES**

#### ***Introduction***

- 3.1 Expenditure that is expected to arise in the future to meet the cost of environmental measures may need to be treated as a liability or, if the existence of an obligation will be confirmed only on the occurrence of an uncertain future event, as a contingent liability. The main issues to be considered in connection with environmental liabilities concern the timing of recognition, the treatment of voluntary commitments, the measurement of liabilities, including discounting and the use of estimates, and the treatment of expected recoveries. Contingent environmental liabilities and impairment of assets are addressed in subsequent sections of this paper.

#### ***Recognition of an obligation***

- 3.2 Recent conceptual frameworks, such as the ASB's proposed statement of principles, have defined a liability as an obligation to transfer economic benefits as a result of past events or transactions. Provisions that might be made on the ground of prudence but for which there is no obligation, such as provisions for the cost of monitoring sites for possible contamination and future remediation work that may be necessary, are consequently excluded. A liability is recognised at the point when the entity becomes obliged to incur the expenditure. In applying this principle to environmental liabilities, the ICAEW discussion paper took to view that environmental expenditure should be recognised as a liability when the entity has an obligation to incur future sacrifices as a result of past events and the expenditure involved is reasonably determined. However, the effects of future legislation should not be anticipated.
- 3.3 An obligation arises if laws are passed that require environmental measures to be taken. Where the obligation cannot be avoided, it would be imprudent to await the effective date of the new legislation before recognising that a liability exists. If there is a legal requirement to rectify environment contamination, a provision for the costs involved should be recognised. Even if the requirement will not be enforced until some future date, such as a delay caused by the need to introduce legislation to implement an EU directive, there is a liability that should be recognised. New laws sometimes impose an obligation for progressive reduction in environmental contamination. Where such future measures are inevitable, for example a stage reduction in emissions, there is an obligation and a liability should be recognised.
- 3.4 A liability may also arise as a result of the discovery of environmental damage that is subject to existing laws. For example, a gradual leak may have occurred in an underground storage tank which is not discovered until some time after the leak took place, such as by the detection of polluted ground water in a borehole drilled many years later (eg The Cambridge Water case). In such circumstances, detection of the pollution would trigger recognition of a liability.
- 3.5 In any case, it may be difficult to judge the point at which environmental damage is inflicted as the damage usually occurs gradually rather than at a particular time. For example, in the case of a landfill site, it could be argued that some damage occurs when the site is first engineered and that further damage is caused when waste is first deposited, when the waste begins to decay and pollutants are generated, and when those pollutants escape from the landfill into the surrounding area. This implies that the provision should be increased at each of these points to reflect the additional damage inflicted, although quantification of the incremental damage at each point may be difficult.

- 3.6 The ASB discussion paper on provisions propose that, except in the rare circumstances when a reasonable estimate of the obligation cannot be made, a provision for environmental liability should be recognised at the time that the entity becomes obliged, legally or constructively, to rectify the environmental damage. The amount provided should reflect the extent of the entity's obligation. A demonstrable commitment would be regarded as one form of obligation to clean up, no provision should be recognised. In either case, the asset should be tested for impairment.
- 3.7 Several respondents to the ASB discussion paper suggested that provision for cleaning up past contamination should be made as soon as the entity becomes aware of the problem rather than when it has an obligation to rectify the damage. This widely held view emphasises the need for adequate disclosure where there is no obligation.

### ***Abandonment costs***

- 3.8 The ASB discussion paper on provisions also addresses the treatment of abandonment costs, often incurred in the extractive industries in dismantling a facility and restoring the site at the end of its life. Similar treatment might be expected to apply in the case of landfill sites.
- 3.9 In the case of abandonment costs, the ASB discussion paper proposed that work which the entity is obliged to undertake should be provided for in full at the time the environmental damage occurs. Whilst the full liability would be recognised in the balance sheet, the corresponding expenditure would be capitalised as an asset, this spreading recognition of the expense in the profit and loss amount.
- 3.10 If there is a long operating licence, most of which is unexpired, with no plans for disposal, it might seem misleading to provide for such costs in full when extraction begins. In many cases, however, the operating licence will stipulate that the site must be restored and any environmental damage minimised when extraction ceases. There is therefore an obligation from the outset. Where there is such clause, it is necessary to determine whether the business has a demonstrable commitment to incur the costs of abandonment.

### ***Voluntary environmental expenditure***

- 3.11 Where an entity intends voluntarily to make good existing environmental damage, it might be argued that this represents a constructive obligation which arises before there is a legal obligation as a result of commercial, social or ethical considerations. A number of different circumstances can be envisaged:
- (a) Pollution of a site may be known to exist that will have to be cleared up at some future date, such as when the site is closed or sold, although there is no immediate requirements or commitment to rectify the damage and consequently no obligation.
  - (b) Where management has identified an opportunity to improve its public relations by reducing emissions from its plant, but is not required to do so, there is no obligation since management remains free to decide to take no action or to address the problem by other means
  - (c) A business may experience commercial pressure, through the supply chain, to achieve or maintain certain environmental standards, leading to a constructive obligation, for which provision should be made.
  - (d) Commercial considerations, such as a threat to long-term reputation of a business if clean up costs are not incurred, may result in a constructive obligation if there is no effective alternative.

- 3.12 If legislation requires a site to be cleaned up only on its disposal but the business has voluntarily decided to clean up the site in the meantime, with no expectation of disposing of it, the decision could often be reversed and the expenditure postponed. Communication of the decision, either to employees or the local community, does not itself create a liability if the decision could realistically be revoked, even though such a reversal may be awkward or embarrassing. By contrast, if such communication gives rise to a demonstrable commitment, from which the business cannot realistically withdraw, a provision for the environmental costs should be made.
- 3.13 Whereas application of the prudence concept might suggest that provision for the liability should be made on a more *flexible* basis, so as to include situations when management decides to adopt voluntary environmental measures, ASB's proposed statement of principles emphasises that an internal decision does not, in itself, give rise to a liability. However, in view of the audit problems that are likely to arise, the ASB might usefully provide further guidance as to what a constructive obligation should comprise.
- 3.14 The ASB discussion paper on provisions proposes that a liability should be recognised when the only when an entity has no realistic alternative to making a transfer of economic benefits as a result of past event. In the absence of a legal obligation, the discussion paper notes that a constructive obligation may exist where an entity has announced that it will reduce or eliminate an environmental problems associated with one of its sites, or that is intends to clean up to a higher standard than that required by law, and the announcement has the effect that the entity cannot realistically withdraw.

### ***Accounting treatment***

- 3.15 Once a demonstrable commitment has been made, the estimate amount payable in future periods to meet the costs of environmental measures should be treated as a liability. The liability should be based on management's best estimate of the expenditure that will be required. If the necessary criteria are satisfied, the amount should be capitalised, thus effectively spreading the cost through an annual depreciation charge.
- 3.16 If there is no demonstrable commitment, the cost of environmental work payments are made. Where the work is to be carried out in phases and the should be charged to the profit and loss account over the periods in which benefit will accrue over a period of years, it may be appropriate to spread the cost in this way.
- 3.17 An obligation for environmental expenditure that is dependent on the outcome of an uncertain external events should be regarded as contingent if it meets the criteria in SSAP 18 "Accounting for contingencies".

### ***Measurement***

- 3.18 An environmental liability should be measured as the estimated amount of future cash flows (adjusted as set out in paragraph 3.21 and 3.22 below) that will be needed to settle the obligation that existed at the balance sheet date, based on the present cost of carrying out the environmental measures required. The amount provided should be discounted where this has a material effect on the provision. The estimated liability should be reviewed in subsequent periods and adjusted as necessary.
- 3.19 Many environmental liabilities are characterised by their substantial and uncertain size, as well as by a lack of precision about their timing. Technological change and the uncertainty of environmental regulations may make it difficult to estimate the provision required. However, some of these problems are not peculiar to environmental liabilities appropriate procedures need to be adopted so that all material liabilities are reported. The ICAEW discussion paper suggested that, where an entity has an environmental liability, provision should be made if the related expenditure can be estimated

are not excluded from financial statements whilst provision is made for less significant items that are more easily measurable.

- 3.20 The ASB discussion paper on provisions proposes that a provision should be recognised unless a reasonable estimate of the amount of the obligation cannot be made, which is only expected to be the case in rare circumstances. The amount of the provision should be the best possible estimate of the expenditure that will be required to settle the obligation. Where the amount cannot be estimated, the nature of the liability and expected timing of the expenditure should be disclosed. Where it is expected that the expenditure will fall within a range of possible amounts, provision should be made for the amount considered to be the best estimate of the expected obligation. Where no amount can be regarded as a best estimate, provision should be made for at least the minimum expenditure; this does not prevent provision being made for a higher figure within the range, such as an amount based on the weighted average of probable outcomes.
- 3.21 Where there is sufficient evidence of expected future events that may affect the amount required to settle an entity's obligation, such events should be reflected in the amount provided. Thus, amount should be taken of future events such as changes in legislation and improvements in technology, provided that there is objective evidence to show that such changes are reasonable expected. It would not be appropriate for measurement of the liability to be based on an unsupported conviction held by the preparer of the accounts, nor should the benefit of unproved or conjectural improvements in technology be anticipated.
- 3.22 In the case of "long-tail" environmental liabilities, the use of discounting may be relevant, although uncertainties as to timing and amount may make the technique more subjective than it is for other liabilities. The ASB discussion paper on provisions proposes that discounting should be required where the effect is material. There is also a brief discussion of discounting in the discussion paper on impairment of tangible fixed assets. We believe that a consistent approach to the use of discounting is necessary and we note that the ASB is likely to issue further guidance as a result of its present project on discounting.

### ***Treatment of expected recoveries***

- 3.23 Environmental liabilities and expected recoveries from a third party are essentially the same as other liabilities and recoveries and in principle should not be treated differently. The Fourth Directive prohibits the offsetting of assets and liabilities, except where a legal right of set off exists, and the Companies Act Sch 4 para 5 includes a similar prohibition of set off, as does FRS5 "Reporting the substance of transactions". On the basis that the liability for environmental costs and the expected recovery comprise two separate transactions, each with its own associated risk and uncertainties, the gross liability and the expected recovery should be evaluated and presented separately in the balance sheet, unless a legal right of set off exists. Thus, for example, proceeds from the expected sale of a property, or from salvage material, should not be offset against the gross liability.
- 3.24 The ICAEW discussion paper supported a gross approach, nothing that inclusion of the recovery in the balance sheet must depend on the degree of certainty involved. The ASB discussion paper on provisions also proposes the prohibition of offset, except where there is no longer a liability to meet the expenditure if the third fails to pay, ie when default by the party from whom recovery is expected would not result in recourse whereby the liability reverts to the reporting entity. Such circumstances rarely arise and would almost certainly be limited to cases where a court judgement has been obtained. In the case of an insurance claim, offset would not be appropriate, even if the claim has been admitted, as there is always a possibility that the insurer may default.
- 3.25 It may be helpful for the notes to the accounts to explain the link between the liability and the recovery. However, it would be misleading to provide for the

liability but only to disclose the expected recovery in a note. To ensure that the liability and the expected recovery are treated with the appropriate degree of neutrality, the required threshold of certainty for recognition should be the same in each case.

## **IV CONTINGENT ENVIRONMENTAL LIABILITIES**

### ***Application of SSAP 18***

- 4.1 The ICAEW discussion paper concluded that SSAP 18 “Accounting for contingencies” provides an adequate framework for dealing with disclosure of contingent environmental liabilities, although the uncertainty involved as to the amount and timescale will often present particular difficulties of recognition and measurement. As a result, there may be greater uncertainty in reporting a contingent environmental liability than in reporting other contingencies.
- 4.2 In its discussion paper on provisions, ASB proposes restricting the recognition of provision to those circumstances where an entity has an obligation to transfer economic benefits as a result of past events and is not free to avoid an outflow of resources. The discussion paper on provisions does not cover contingent liabilities, leaving them to be dealt with by SSAP 18.
- 4.3 There would be advantages in reviewing the requirements of SSAP 18 so as to address the issues raised by contingent environmental liabilities. For example, unless there is a demonstrable commitment, a chemical company reporting under the going concern concept does not recognise the cost that would be associated with cleaning up contaminated land within its own premises, as these costs would only arise in the event of closure and sale. In such a case, the going concern concept does not assume indefinite occupation but it should be clarified whether an eventual disposal of the site constitutes an “uncertain future event”.

### ***“Probable loss” versus “reasonably possible loss”***

- 4.4 The CICA research report concluded that disclosure environmental liabilities should include:
  - (a) “reasonably possible” future environmental expenditure related to past events or transactions; and
  - (b) “reasonable possible” environmental losses that could have a significant effect on future cash flows.

If the possibility of an environmental loss relating to past events or transactions is remote but the impact could have a significant impact on future cash flows, the view was taken that it is desirable to disclose this possibility.

- 4.5 Such disclosure would go further than the current UK requirement under SSAP 18 and we believe that there would be a risk that users may draw unreliable conclusion from this information. In the case of a loss that is contingent on a particular event, it is questionable whether a distinction can be drawn between *probable* loss and *reasonably possible* loss. It might be argued that probability should be supported by statistical evidence and that this is not necessary to show that a loss is reasonable possible. Nor is this a problem that is unique to environmental liabilities. We therefore support the continued application of SSAP 18, with its focus on *probable* loss.

### ***Disclosure of contingent environment liabilities***

- 4.6 A general statement within management’s discussion of the nature of the business, referring to any significant environmental risk, may be appropriate. This is acknowledged in the ASB’s statement of the OFR, in which environmental protection costs and potential liabilities are given as examples of matters that may be relevant for inclusion in a discussion of the risks and uncertainties relating to the business. If there is a persistent risk, care needs to be exercised in striking a balance between a bland statement

that is repeated each time an entity reports and the alarm that might be caused by a reference to specific, but unqualified, risks.

- 4.7 Some respondents to the ICAEW discussion paper argued that there should be a mandatory disclosure requirement that would highlight environmental risks. Whilst such risks may be significant, financial statements do not currently reflect the incidence of risk. In the present context, the OFR probably provides a more suitable medium for discussing the wide range of risk and uncertainties to which business is exposed. The ACBE consultation paper<sup>3</sup> supported this view but also observed that there is no commonly agreed definition of environmental risk.
- 4.8 Respondents to the discussion paper also note that the “trade-off” between relevance and reliability, as in other circumstances, needs to be considered. Whilst the risk of future environmental liabilities should be concealed, information about potential claims for environmental damages may be relevant but highly uncertain as to the amount or timing of any settlement. If the validity and amount of the claim is disputed, it may be inappropriate to recognise the claim as a liability but it should be disclosed as a contingent liability, if the existence of the claim has been made public or if there is a likelihood that it will result in a commitment.

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<sup>3</sup> Consultation paper “Environmental reporting and the financial sector”, published by the Advisory Committee on Business and the Environment (ACBE) in April 1996

## ***V IMPAIRMENT OF ASSETS***

### ***Recognition***

- 5.1 The ICAEW discussion paper noted that the issue of impairment is not unique to assets affected by environmental factors and that, whilst the general principles of reviewing asset values for possible impairment should apply equally to environmental impairment, this type of impairment carries particular uncertainties regarding timescale and amount.
- 5.2 Publications of the ASB discussion paper on impairment of tangible fixed asset may help to clarify some of the issues. However, the discussion paper deals with impairment generally and does not address any specific issues relating to environmental impairment, although the same principles would apply. For instance, two of the examples in the paper concern the effect of a new law prohibiting the manufacture of a product by a process which results in toxic fumes and the effect of noise on a hotel situated under the flight path of a new runway.
- 5.3 The ASB discussion paper on impairment proposes that the existence of impairment should first be confirmed by an “impairment review”. The need for such a review may arise in a number of circumstances, for example when there is a significant change in the environmental legislation relating to the business in which the asset or group of assets is involved. If there are indications of impairment, an impairment test should be carried out to assess the extent to which the recoverable amount of an asset is less than its book value. Any such impairment should then be recognised by reducing the book value of the asset to its recoverable amount.
- 5.4 Further development of the ASB discussion paper on impairment will need to clarify the linkage with related topics, such as the valuation and depreciation of fixed assets. Where an asset is the subject of environmental damage which the entity has an obligation to clean up, the asset would be subject to an impairment test. If there is no such obligation or commitment, the valuation of asset valued on the basis of ‘open market value for existing use’ may not reflect the expected clean up costs and ‘open market value for alternative use’ would provide a more realistic valuation. Prior to the existence of an obligation to clean up, an impaired asset should be carried at a reduced amount to reflect the contamination. When the obligation for clean up arises, a liability should be set up and the diminution in value written back.

### ***Measurement***

- 5.5 Some respondents to the ICAEW discussion paper suggested that there is a risk of double counting of environmental losses if the impairment of assets is recognised as well as making provision for environmental costs. Provided the process is properly applied, double counting should not arise. For example, in carrying out an impairment test, it should be borne in mind that the calculation of environmental provisions should have taken account of all the future cash outflows involved in cleaning up contamination. However, as recognised in the ASB discussion paper on provisions a further impairment may arise if clean-up operation for which provision has been made is not expected to remove all the contamination
- 5.6 The ICAEW discussion paper suggested that, in measuring impairment, the net recoverable amount of an asset would normally be determined by reference to the future cash flows from its use, based on management’s best estimates. As in other cases involving future cash flows, the paper mentioned that the use of discounting may be appropriate.
- 5.7 The ASB discussion paper on impairment proposes that the valuation of impaired assets should be based on the assessment of the net present value of expected future cash flows and that the amount concerned should be discounted. In considering future cash flows and that the amount concerned

should be discounted. In considering future cash flows, prudence would normally require the application of greater caution in relation to cash inflows than cash outflows. In the case of environmental impairment, future cash outflows may be impossible to predict or quantify. The need to reflect such uncertainty is therefore particularly relevant in the case of assets that are impaired due to environmental reasons.

- 5.8 The FASB accounting standard FAS 121 “Accounting for the impairment of long-lived asset...” requires that an initial test for impairment should be carried out on an undiscounted basis, and that, if impairment has occurred, its measurement should be done on a discounted basis. The ASB’s proposed approach is to use a discounted approach for the impairment test as well as the measurement of impairment, although an impairment test would be required only if there is some indication of a possible impairment. In most circumstances, this will lead impairment being recognised more frequently in the UK than in the US. Although there are valid arguments for each approach, we believe that the ASB’s proposals are conceptually superior.

## **VI DISCLOSURE**

### ***Introduction***

- 6.1 The purpose of environmental disclosure is essentially the same as that of disclosure generally. Where environmental issues are dealt with in financial statements, the objective is to provide information about their impact on the financial position and performance of an enterprise that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions. This is consistent with the objective of financial statements, as set out in the ASB's draft "Statement of principles for financial reporting". A balance between the needs of different users is necessary, as financial statements cannot be expected to give all user groups all the information they want. This is particularly true in the area of environmental disclosure, and for practical purpose, shareholders are seen as the primary users.
- 6.2 The CICA research study concluded that disclosure should comprise:
- (a) a description of what is included in the definition of "environmental costs";
  - (b) the basis on which environmental costs are capitalised or charged direct to the profit and loss amount;
  - (c) if environmental costs are capitalised, the basis of which such costs are amortised to income; and
  - (d) the basis on which environmental liabilities are recognised.
- 6.3 The ICAEW discussion paper supported those broad principles as being consistent and applicable to all entities for which environmental considerations are significant. Where the disclosure or non-disclosure of environmental costs and liabilities may influence decisions by users and the information concerned would thus satisfy the normal criteria for materiality, it was suggested that disclosure should be made. For those entities that do not present an OFR, the discussion paper noted that the directors' report or the chief executive's statement may be an appropriate place for a description of environmental issues affecting the entity. In each case, it is necessary to strike a balance between making a general statement about the treatment of environmental issues and providing a detailed description of specific valuation methods.

### ***Environmental costs***

- 6.4 As stated in paragraph 1.1 of this paper, the disclosure of environmental costs as an item distinct from other costs is not presently required unless such costs are so significant that they need to be separately disclosed as an exceptional item in order to show a true and fair view. Such disclosure should be clarified by an explanation of the basis on which environmental costs are identified. One of the questions considered in the ICAEW discussion paper was whether any particular disclosures are appropriate as regards accounting policies, environmental costs, liabilities and contingent liabilities for future environmental expenditure.
- 6.5 A number of respondents appeared to support a distinction between:
- (a) incremental costs incurred in meeting statutory requirements, writing down assets whose costs are irrecoverable, or in adopting voluntary environmental measures;
  - (b) fines and penalties for non-compliance with legislation and compensation for environmental damage; and
  - (c) environmental clean-up costs and other environmental expense for which there is not expectation of future benefit.

Some respondents argued that it would be appropriate to split the first category between costs incurred compulsorily and those incurred voluntarily, on the grounds that this distinction increases users' understanding the reduces the likelihood of potentially misleading information.

- 6.6 The categories set out above will often be helpful as a voluntary form of disclosure, although the analysis may not provide sufficiently useful information to justify the additional burden. No distinction should necessarily be made between mandatory and voluntary expenditure, as voluntary measures may involve bringing forward mandated expenditure or archiving a higher environmental performance than is strictly required.
- 6.7 If environmental costs are disclosed, the inclusion of fines and penalties within the definition can be misleading if there is an implication that a high or increasing figure should be interpreted favourably. There may also be a need to distinguish between fines and compensation paid to third parties, eg to the purchaser of a contaminated site.

### ***Capitalised environmental costs***

- 6.8 Some respondent to the ICAEW discussion paper suggested that there should be a requirement for capitalised environmental costs to be separately disclosed. In certain circumstances, it may be to an entity's advantage to explain the beneficial environmental effect of any capitalised expenditure. On the other hand, where such costs form part of the capital cost of new plant or equipment, it may not be appropriate to provide a separate figure.

### ***Provisions for environmental liabilities***

- 6.9 The ASB discussion paper on provisions propose the following general principles for disclosure of each material class of obligation that meets the criteria for recognition:
- (a) a brief description of the nature of the obligation, including an indication timing and, where there is significant uncertainty over the amount or timing of the expenditure, the factors that are relevant to their determination;
  - (b) the amount provided and, if estimated, the basis on which the estimate has been made;
  - (c) where the provision has been discounted, a statement to this effect together with the type of rate used and, where relevant, a reference to any allowance for risk or a statement that no allowance has been made for risk; and
  - (d) the movement in each material class of provisions during the year.
- 6.10 These disclosures are framed in general terms, but where provisions for environmental liabilities are significant, separate information may need to be provided. Where an entity would be unable to distinguish between environmental provisions and other obligations, such as when remedial work involves other benefits, such a distinction may not be readily available, although it should be borne in mind that the ASB discussion paper proposes that disclosures should be given for each class of provision. Additional disclosure that were believe may be helpful would include a brief description of the environmental damage, any laws or regulations that require its remediation, and any expected changes in the law or in existing technology that are reflected in the amount of the provision or the timing of the expenditure.

### ***Impaired assets***

- 6.11 The ASB discussion paper on impairment proposes that an entity should explain the reason for any significant impairment of an asset, identifying the business “unit” in which the impairment arises and the measurements basis adopted. In this respect, no special treatment is required regarding environmental impairment.

### ***Other disclosures***

- 6.12 Under SSAP2 “Disclosure of accounting policies”, the accounting policies followed for dealing with items which are judged material or critical in determining the profit or loss for the year and in stating the financial position should be disclosed by the way of note to the accounts.
- 6.13 Where environmental costs and liabilities are significant, the accounting policies should explain whether the amount concerned are those which relate “wholly and exclusively” to preventing, reducing or repairing damage to the environment or whether they are based on a comprehensive allocation of costs.

## VII CONCLUSION

7.1 The important points arising this paper and from the other documents on which it is based may be summarised as follows:

- Management commentary on any material environment issues affecting, or likely to affect, the enterprise should be regarded as good practice, applicable to all entities.
- Whilst there is generally no need to account for environmental costs in a different way from other costs, the recognition of environmental liabilities may require greater clarity in identifying and defining the underlying costs, since they often involve greater uncertainty as regards their timing and measurement.
- Environmental costs should be recognised as soon as the entity has an obligation.
- Whether environmental costs are derived from a comprehensive allocation of costs or by using a “wolly and exclusively” approach, any figure that is disclosed should be accompanied by a description of the basis adopted.
- Environmental costs should only be disclosed if they satisfy the normal criteria for materiality, ie if the costs are sufficiently material in relation to income or other items of expenditure that the information could influence the decisions of users of the financial statements.
- Environmental costs relating to prior years should be charged in arriving at the profit or loss for the year, with separate disclosure if the amounts are material, and not shown as a prior year adjustment.
- Environmental costs that provided access to future economics benefits, including the continued operation of an asset, should be capitalised.
- A capitalised environment cost that is directly related to another capital asset should be included as part of the cost of that asset.
- Provision should be made for all environmental liabilities for which an entity has an obligation, including a constructive obligation, except for the rare cases where a reasonable estimate of the obligation cannot be made.
- An environmental liability should be measured as the estimate amount of future cash flows that will be needed to settle the obligation. The amount provided should be discounted where this has a material effect on the provision.
- Environmental liabilities and expected recoveries from third parties should be estimated separately and should not be offset, except in the rare case where there is no possibility of recourse in the event of default by the party from whom recovery is expected.
- Environmental liabilities that are contingent on an uncertain future event should be recognised if it is probable that they will arise; if it is not possible to make a reasonable estimate of the amount of the contingent liability, its nature and existence should be disclosed.
- Environmental impairment of an asset should be recognised by reducing its carrying amount, so as to reflect its current value; care is necessary to ensure that no double-counting arises through recognising impairment of an asset as well as making a provision for environmental costs.
- Financial statements should be included a description of the accounting policies relating to any significant environmental costs and liabilities that are disclosed.

- 7.2 In broad terms, the Environment Steering Group believes that the treatment of environmental issues in financial reporting is covered by existing UK accounting requirements or will be addressed by financial reporting standards currently under development
- 7.3 As mentioned in the introduction, this paper is designed to assist preparers and users of financial statements in interpreting the existing framework as well as promoting debate. Given the changing nature of environmental legislation and financial reporting issues generally, we recommend that the framework should be subject to ongoing review.