2 October 1998

REL/JP/ENVROME.DOC

GLOBAL ACCOUNTING RULES ON GREEN ISSUES

- REVIEW OF INTERNATIONAL ACCOUNTING STANDARDS

FOR ENVIRONMENTAL ISSUES

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Preface

1. The paper that follows is based on a memorandum prepared for the Fédération des Experts Comptables Européens (FEE) that was submitted to the International Accounting Standards Committee (IASC) in February 1998. Since then, FEE has been informed that the Executive Committee of IASC will recommend to the IASC Board that a project on environmental issues should be undertaken as soon as the programme of "core standards" agreed with the International Organization of Securities Commission (IOSCO) has been completed. Such a move would be welcome and extremely timely, given the increasing importance attached to such issues in many countries.

Introduction

2. In his presentation to the World Congress of Accountants held in Paris in October 1997, Michael Sharpe, the IASC Chairman at that time, confirmed that he regarded environmental issues as an important focus for IASC work as soon as the set of "core standards" are in place.

3. In submitting the memorandum, FEE suggested that it will be necessary to consider whether individual standards should be expanded by the inclusion of additional requirements or implementation guidance. We also decided to give the memorandum wider circulation, as a contribution to the debate and as a possible source of guidance for any preparers who wished to review the way in which their financial statements deal with environmental issues.

4. The purpose of the paper was to consider those standards that are relevant to environmental issues, the extent to which guidance is available and areas where it would be helpful for the IASC to elaborate on its existing recommendations, so as to ensure that

financial statements properly reflect environmental issues. On balance, FEE does not believe that a separate international accounting standard on environmental issues is necessary.

5. In preparing the paper, reference was made to a paper on environmental issues in financial reporting issued by the EC Accounting Advisory Forum and to a statement of position prepared by the UN Working Group on International Standards of Accounting and Reporting (ISAR).

GENERAL

6. On a number of occasions, it has been suggested that environmental issues may arise on which there is no relevant guidance within the existing set of International Accounting Standards. There is also a view that environmental liabilities and asset impairment are not unique and that the accounting principles set out in the standards are already adequate to deal with the problems that may arise. To some extent, both positions can be justified; the observations that follow consider some of the issues in more detail.

7. Whilst most of the documents reviewed would benefit from the inclusion of some reference to the fact that users of financial statements need information about the environmental issues affecting an enterprise and their financial implications, the following areas are those in which the main changes are likely to be necessary:

   (a) The IASC Framework for the preparation and presentation of financial statements should draw attention to the need for a narrative discussion about environmental risks, where these exist, and explain that an item of a relatively small amount that may not be material in itself may be significant in its impact on a company's reputation and public image. (Paragraphs 9-12)

   (b) IAS 1 should require the separate disclosure of environmental costs and liabilities[1] where these are material to the enterprise, i.e. where the effect of the information on the financial position, performance and changes in financial position of the enterprise could influence the economic decisions of a wide range of users of the financial statements. Where environmental costs are separately disclosed, the accounting policies should state what these costs represent, the accounting treatment adopted and, in the case of environmental costs that are capitalised, whether the amount concerned is derived from an allocation of total costs, or is restricted to those costs that relate "wholly and exclusively" to environmental factors. (Paragraphs 13 - 17)

   (c) IAS 16 provides some guidance on the treatment of environmental expenditure relating to property, plant and equipment but should clarify the criteria for

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[1] The IASC should establish a definition of environmental costs and liabilities. Amongst the various definitions that have been put forward, the following offer a suitable starting point:

Environmental costs comprise the costs of steps taken or required to be taken to manage the environmental impacts of an enterprise's activity and to meet the environmental objectives of the enterprise.

Environmental liabilities are obligations relating to environmental costs that are incurred by an enterprise and meet the criteria for recognition as a liability.

capitalisation as regards whether an *increase* in expected economic benefits, rather than *continued* economic benefits, is required. (Paragraphs 18 -23)

(d) IAS 36 should address the problems of measuring impairment of assets due to environmental factors, the difficulties of determining the recoverable amount and the uncertainties as regards the timing involved. Reference should also be made to the stigma effect that environmental impairment may have on potential purchasers. (Paragraphs 24 - 27)

(e) IAS 37 should acknowledge the difficulties in recognising and measuring provisions for environmental costs; it is also a matter for concern that adopting a restrictive approach in such cases may have the undesirable effect that a provision for clean up costs is not recognised when it would be prudent to do so. It should also provide more specific guidance to ensure that environmental liabilities that are contingent on an uncertain future event are recognised if it is probable that they will arise and that, where it is not possible to estimate the amount of the liability, its nature and existence are disclosed.(Paragraphs 28 - 31)

(f) IAS 38, the standard resulting from E60, should clarify whether such items as pollution permits and emission rights, that are increasingly used in the environmental area, would meet the criteria for recognition as intangible assets. (Paragraph 32)

8. Whilst International Accounting Standards are at present limited to those matters that affect the presentation of financial statements, it seems likely that, once the programme of core standards is completed, the IASC will wish to develop a statement on narrative disclosures, such as those given in the operating and financial review (OFR) or in the management discussion and analysis (MD & A). In this event, there will be a strong case for requiring a discussion of the principal environmental risks and uncertainties, including environmental protection costs and potential environmental liabilities.

FRAMEWORK AND STANDARDS

Framework for the preparation and presentation of financial statements

9. In summarising the objectives of financial statements, the framework refers to the notes and supplementary schedules which "may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognised in the balance sheet". Depending on the nature of the business, matters that may be relevant include environmental protection costs and potential environmental liabilities, to the extent that material risks and uncertainties exist. In some industries, the absence of a commentary describing management action taken to minimise the effect of such environmental factors may be viewed with concern by users.

10. One of the key underlying assumptions in preparing financial statements, identified in paragraph 23 of the framework, is that of going concern. In this respect, it should be borne in mind that environmental issues are unique in that, if an enterprise fails, it is often society as a whole, or the local population, that has to meet the cost; in other cases of failure, it is normally creditors and shareholders who suffer.

11. The materiality of an item depends on its size, nature and circumstances although, as the framework notes, in some cases, the nature of information alone is sufficient to

determine its relevance. The nature of an item is governed by such factors as the events giving rise to it, its sensitivity, normality and potential consequences. Environmental remediation costs, fines or penalties may need particular consideration in this respect. Relevant circumstances include the nature of the industry concerned and any changes that are foreseeable. The increasing development of environmental awareness, both generally and in respect of certain industries, may be regarded as part of these changing circumstances.

12. For some types of environmental liability, it may be impossible to judge the consequences of contamination, the costs of remedial treatment or of process licensing or the effects of technical obsolescence. An item of relatively small amount may not be material in itself but may be material in the context of an enterprise's particular circumstances. For example, a fine for a small amount may be highly significant to a company's reputation and public image, and a low level of environmental expenditure may be material if the context would lead the user to expect the item to be a substantially greater amount.

IAS 1 Disclosure of accounting policies

13. IAS 1 requires that all significant accounting policies should be disclosed in the notes to the financial statements. With the growing significance of environmental issues affecting many businesses, it is possible that reference will be needed to the way in which environmental liabilities and impaired assets have been treated. For enterprises operating in environmentally sensitive sectors, such as the chemical industry, or holding large land banks, the absence of a stated policy may be a cause for criticism.

14. There are no requirements in IAS 1 that would result in the separate disclosure of environmental costs or liabilities. Environmental costs are rarely disclosed separately, unless they represent an exceptional item, and there is often no reason to treat such 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 uncertainty as regards their timing and measurement. The disclosure of such information, together with an appropriate explanation, is likely to be expected by users in view of the increasing importance of the environment. Where environmental costs are disclosed, the way in which such costs are identified should also be explained, in order to ensure that comparisons between enterprises do not result in misleading conclusions.

15. In a paper[2] published in 1996, it was argued that, if an enterprise discloses environmental costs, the figure should not be an allocation of total costs but should be confined to those costs which relate "wholly and exclusively" to preventing, reducing or repairing damage to the environment. Whatever approach is adopted, any figure that is disclosed should be supported by a description of the basis used.

16. The paper issued by the EC Accounting Advisory Forum excludes from the definition of environmental expenditure "costs incurred as a result of fines or penalties for non-compliance with environmental pollution and similar environmentally related costs." Costs of this nature need to be taken into account in any assessment of environmental performance. Separate disclosure would therefore be appropriate where fines or

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[2] "Environmental issues in financial reporting" ICAEW (October 1996).

penalties are significant; in this context, materiality should be viewed in relation to the nature of the item as well as its size.

17. The standard also requires that fundamental accounting assumptions are followed in preparing financial statements. The enterprise is normally viewed as a going concern, i.e. that it will continue in operation in the foreseeable future. By adopting the concept of a going concern, it is assumed that the enterprise has no foreseeable prospect of liquidation or of materially curtailing the scale of its operations. Circumstances in which this might be necessary may include premature closure or curtailment for environmental reasons, either as the result of an unplanned discharge or other occurrence, or due to the impact of legislation. In an extreme situation, non-compliance with environmental laws or regulations may affect the continuance of an entity as a going concern.

IAS 16 Property, plant and equipment

18. IAS 16 deals with the recognition and measurement of property, plant and equipment. Although impairment is addressed briefly in IAS 16, as regards the need for a periodic review to compare the carrying amount of an item with its recoverable amount, more comprehensive guidance would be appropriate in IAS 36 on Impairment of assets.

19. Property, plant and equipment may be acquired partly or mainly for environmental reasons. In broad terms, as in the case of other items, capitalisation is appropriate if the expenditure is expected to result in future economic benefits to the enterprise.

20. Paragraph 24 of IAS 16 permits subsequent expenditure relating to an item of property, plant and equipment to be capitalised only when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing asset, will flow to the enterprise. Paragraph 27 explains that, if the carrying amount of the item already takes account of a loss in economic benefits, subsequent expenditure to restore the future economic benefits expected from the asset is capitalised. This would normally be subject to an impairment test.

21. The question therefore arises as to whether capitalisation of subsequent expenditure that simply enables existing property, plant, and equipment to *continue* to produce future economic benefits, rather than increase those benefits, is permitted. It needs to be clarified that even though no *increase* in future economic benefits is produced, such acquisitions qualify for recognition as assets. In the case of environmental expenditure, the mitigation of environmental damage and the avoidance of future closure, for example where new laws would otherwise require an enterprise to curtail its operations, should be regarded as a form of future benefit. While not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, the acquisition may be necessary to enable the enterprise to obtain future economic benefits from its other assets.

22. IAS 16 requires that, if the recoverable amount of an item of property, plant and equipment has fallen below the carrying amount, due to impairment, the carrying amount should be written down and the reduction should be recognised as an expense. Assets acquired are only recognised to the extent that the resulting carrying amount involved does not exceed the total amount recoverable from that asset and related assets. For example, a chemical manufacturer may have to install new chemical handling processes in order to comply with environmental requirements. Related plant enhancements are

recognised as an asset to the extent that they are recoverable because, without them, the enterprise is unable to manufacture and sell chemicals.

23. Where an enterprise purchases a contaminated asset and the purchase price includes an allowance for the cost of remedial work for which the acquirer has an obligation, it could be argued that, to avoid "double-counting", the asset should be included at an unimpaired amount and provision made for the remedial costs. On the other hand, E61 on Business combinations would suggest that the acquirer's perspective is not relevant, in which case no provision is made and the asset should be measured at the impaired amount. In any event, the appropriate treatment should be clarified.

IAS 36 Impairment of assets

24. In June 1998, the IASC published IAS 36 on Impairment of assets. Whilst the general principles of reviewing asset values for possible impairment should apply equally to assets affected by environmental factors, this type of impairment often carries particular uncertainties regarding estimation of the timescale and recoverable amount. Paragraph 9 of IAS 36 lists a number of indications of possible impairment. These include significant changes with an adverse effect on the enterprise that have taken place during the period or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated. Although the list is described as being "not exhaustive", environmental factors, both internal and external to the enterprise, such as contaminated land, should be mentioned as a possible indicator of impairment. IAS 36 does not specifically address the problems involved in measuring the related impact of such environmental factors on asset values. Guidance in this area should be developed.

25. IAS 36 attaches little importance to the relevance of management intent in determining the appropriate accounting treatment. A bias against such factors is difficult to justify in the case of environmental impairment, where an enterprise's plans for repair or abandonment are may be a key consideration. A board decision to become more environmentally friendly, with the regular publication of on enterprise's policy, targets and achievements, is likely to lower the threshold at which an asset would be considered to be impaired.

26. Measurement of an environmentally impaired asset may be affected by:

(a) delayed disposal of the asset, due to the need to deal with contamination, resulting in clean up costs and increased interest charges;
(b) uncertainties due to the possibility of improvement in related technology or changes in legislation; and
(c) risks arising from the stigma effect, deterring potential purchasers and resulting in a more restricted market.

27. Stigma is an aspect of asset contamination arising from various factors ranging from possible public liability and additional health hazards to fear of the unknown. It might be regarded as the extent to which diminution in value of an asset attributable to the existence of contamination exceeds the costs attributable to: remediation of the asset, the prevention of future contamination, any known penalties or civil liabilities, insurance and future monitoring. Paragraph 78 of IAS 36 mentions that the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit but the standard does not extend this approach to the

impact of contaminated land. Whilst the stigma effect might be recognised in practice by applying a further discount to the value of an asset after allowing for all expected remediation costs, the standard should refer to this problem. Where the effect cannot be measured reliably, e.g. where there have been no disposals of comparable contaminated sites, adequate disclosure should nevertheless be made.

IAS 37 Provisions, contingent liabilities and contingent assets

28. The recognition and measurement of provisions and the disclosure of contingent liabilities are the main areas in which environmental issues are likely to have an impact on financial reporting. In September 1998, the IASC published IAS 37 on Provisions, contingent liabilities and contingent assets, which broadly reflects the proposals in the exposure draft E59, issued in August 1997. IAS 37 requires that a provision should be recognised when an enterprise has a present legal or constructive obligation as a result of a past event which can be reliably estimated and it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation. Clean-up costs and penalties for unlawful environmental damage are mentioned in paragraph 19 of the standard as examples of obligations that would lead to such an outflow of resources, regardless of the future actions of the enterprise.

29. Environmental issues are likely to give rise to one or more of the following questions:

(a) Whether there is a present obligation. The standard acknowledges (paragraph 15) that, in rare cases, it is not clear whether there is a present obligation. It mentions that an enterprise should take account of all available evidence, including expert opinion, in order to resolve the issue. Further guidance may be necessary to ensure that such expertise is appropriate to the circumstances and to reduce the scope for differing interpretations.

(b) Whether a constructive obligation arises in circumstances where there is no legal obligation. Under IAS 37, a constructive obligation is an obligation that derives from an enterprise's actions, where past practice or a published statement or policy indicates that it will accept responsibility and the enterprise has thus created an expectation that it will discharge that responsibility. A position paper developed in February 1998 by the UN - ISAR working group introduced the concept of an *equitable* obligation. This might be regarded as a form of constructive obligation that arises where an enterprise has an ethical or moral duty to clean up environmental damage. In this context, it is also relevant to note that IAS 37 envisages that an obligation may be *to the public at large* (paragraph 20). However, where the enterprise can avoid future environmental expenditure, such as by delaying the fitting of smoke filters, paragraph 19 of the standard prohibits the recognition of a provision.

(c) Whether a proposed change in the law that has yet to enacted gives rise to an obligation. Paragraph 21 mentions that an event that does not give rise to an obligation immediately may do so at a later date because of changes in the law. However, paragraph 50 emphasises that the effect of possible new legislation is (only) taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The standard observes that, in many cases, sufficient objective evidence will not exist until the new legislation is enacted.

(d) Whether problems of uncertainty, either as regards the timing of clean-up or technology available, prevent the amount of the obligation being measured with sufficient reliability. In such circumstances, IAS 37 requires a contingent liability to be disclosed. Where the effect of the time value of money is material, such as a present obligation that will result in cash outflows some time after the balance sheet date, the provision is discounted to present value. This presupposes that the timing involved and the appropriate discount rate can be determined with sufficient reliability. A related uncertainty concerns the technology that will be available when the clean-up occurs. The standard suggests that the amount of the provision to be recognised should reflect the reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up (paragraph 49). However, it goes on to emphasise that the development of new technology should not be anticipated unless supported by sufficient objective evidence.

30. Where there is an obligation for which provision is made or a contingent liability that is disclosed, the financial statements are required to include a brief description of the nature of the item. In the case of a provision, disclosure includes the expected timing of any expenditure, an indication of the uncertainties involved and the amount of any expected reimbursement. In the case of a contingent liability, the estimated financial effect, uncertainties involved and the possibility of any reimbursement are only required to be disclosed *where practicable*. Given that many environmental liabilities arise over a long term and are therefore difficult to determine because of uncertainties about future legislation, the extent and timing of clean-up that will be required and the technology available, a provision may not be recognised under the strict criteria in IAS 37 even though it is probable that expenditure will be necessary. In such circumstances, it is important that the existence of a contingent environmental liability should at least be disclosed.

31. Appendix C to IAS 37 provides some helpful examples to illustrate the application of the standard in various circumstances, including cases of cleaning up contaminated land and the adoption of preventative environmental measures (the fitting of smoke filters). In the case of smoke filters that are not fitted by the effective date of the relevant legislation, it seems counter-intuitive that this is treated as the absence of an obligating event and that provision is only recognised for an obligation to pay fines or penalties. Where legislation has only recently been introduced, estimating the amount of such penalties may be more difficult that predicting the cost of fitting smoke filters. In any case, an enterprise would normally wish to adopt the more positive step of recognising a provision for fitting smoke filters, particularly if it intends to take such a measure within the foreseeable future. The example could therefore be misleading. It may also suggest that the rules regarding an *obligating event* need to be reviewed to enable situations such as the failure to fit smoke filters to be treated as the obligating event.

EXPOSURE DRAFTS

E60 Intangible assets

32. In August 1997, the IASC issued an exposure draft, E60, on Intangible assets, proposing a 20 year ceiling on the amortisation of goodwill and other intangible assets, as a rebuttable presumption. A new standard, IAS 38, has been approved but has not yet been issued, pending finalisation of certain amendments to IAS 22 on Business combinations that might have an impact on IAS 38. The development and increasing use of certain

intangible assets in the environmental area, such as pollution permits and emission rights, would appear to meet the criteria for recognition, in that they are likely to result in future economic benefits to the enterprise, which would otherwise be unable to operate, and have a cost that can be measured reliably. It would be helpful to clarify this point. Whilst E60 generally avoids giving examples of intangible assets, paragraph 95 lists classes of assets for disclosure purposes; intangible assets relating to the environment would presumably be treated as a separate class.

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