

Issues Analysis: Liability for Contaminated Sites

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Introduction

- .01 This issues analysis is a supporting document to the Public Sector Accounting Board (PSAB) Exposure Draft (ED), “Liability for Contaminated Sites.” It provides information on how significant matters arising from comments received on the Statement of Principles (SOP), “Liability for Remediation and Mitigation of Contaminated Sites” have been dealt with in the ED. The analysis has not been issued under the authority of PSAB. Prior to approving a final standard, the Board will review and deliberate responses submitted to the ED.

Scope

- .02 Respondents to the SOP generally supported the scope of the standard. However, some felt that the scope should include liabilities for remediation of contamination resulting from ongoing operations.
- .03 A liability resulting from ongoing operations would generally fall within the definition of an asset retirement obligation (ARO). That is, a legal obligation associated with the retirement of a tangible long-lived asset that results from its acquisition, construction, development or normal operation.
- .04 Accounting and reporting issues for an ARO are unique and different from those related to a liability for contaminated sites. The objective of recognizing an ARO is to report the true cost of the related asset and to allocate that cost in a systematic and rational manner to operations over the life of the asset. An ARO is recognized in the period in which it is incurred, which would normally be upon acquisition of the asset. It may also be recognized over more than one reporting period when the obligation results from normal operations. An ARO may involve more than an obligation to remediate contamination caused by ongoing operations. It could also involve such things as removal of facilities and restoration of a site to its original condition. The Board considered the issue of AROs and decided that other sources of GAAP deal with the issue.
- .05 As a result, the ED remains focused on recognition and measurement for liabilities for remediation of the contaminated site that is no longer active. Since there are no ongoing operations against which to allocate the costs, the recognition and measurement issues are different than AROs.

Recognition

Enforceability

- .06 The SOP proposed that only legally enforceable obligations resulting from an authoritative environmental standard existing in legislation, contract or agreement can create a liability. Breaches of such environmental standards would be legally enforceable through the courts or through administrative proceedings under legislation. The SOP proposed that a constructive and equitable obligation could be recognized when it was legally enforceable under the legal principle of promissory estoppel.

- .07 The SOP proposed that voluntary compliance with non-regulatory environmental standards created by internal policy of the government or guidelines developed by external organizations that have no enforcement capability (for example, the Canadian Council of Ministers of Environment) would not create a liability. Without legally enforceable legislation, contract or agreement, it is difficult to differentiate between those instances when a government is actually bound by an obligation and those that are based on intention or policy of the government.
- .08 Respondents commented that there was a risk that the standard would set a higher threshold for recognition of a constructive and equitable obligation than LIABILITIES, Section PS 3200. Respondents stated that a government may have an established past practice or public policy of remediating contaminated sites even though there is no legislative requirement to do so. A government has an inherent obligation to remediate a site when there is imminent and substantial endangerment of public health and safety or the environment that could result in a liability. Similarly, a government may have an obligation to remediate a site when no responsible third party can be identified or, if identifiable, does not have the resources to carry out remediation.
- .09 The ED proposes that, when a government has a public policy or an established pattern of past practice of remediating contaminated sites in accordance with non-regulatory environmental standards or assuming responsibility when there is no legislative requirement for it to do so, it may have a present obligation. Barring evidence to the contrary that it will continue its past practice, it may have created a valid expectation among others that leaves it little or no discretion but to take action. Not all established patterns of past practice or policy decisions lead to a loss of discretion. If a government has discretion to alter its policy or past practice, it may not have a present obligation.
- .10 In this situation, the determination of whether a present obligation exists can be a matter of professional judgment and require careful consideration of the definition in LIABILITIES, Section PS 3200. Only those obligations for remediation that meet the definition of a liability should be recognized. Obligations based on intention or policy of a government may not meet the definition of a liability or satisfy the three essential characteristics of a liability. An intention to incur expenditure in the future is not sufficient to give rise to a present obligation, even if the outflow is necessary for the government to fulfill its inherent responsibilities.
- .11 Several respondents argued that a government may have to assume responsibility for remediation when there is a threat to human health or safety or the environment because of its inherent responsibility to protect both. The differentiation between which commitments should be recognized and reported in government financial statements is not always clear and requires the exercise of professional judgment.
- .12 The inherent responsibility of a government to protect public health and safety or the environment may be similar to other programs that governments must provide to the public, whether embedded in legislation or constitutional responsibility, such as health

care, welfare or education. Governments may create an expectation by the public that it will continue to provide such services. Canadian standards generally hold that present obligations do not include a government's obligation related to ongoing programs. In these cases, governments do not have a present obligation to others and maintain complete discretion as to whether to change the quality of their programs or the delivery of these programs.

Impact of legislative changes

- .13 The SOP proposed that only legislation that is in effect at the financial statement date would result in the recognition of a liability.
- .14 One respondent commented that there may be occasions when substances are present at a site that would exceed the maximum concentrations allowed in proposed legislation that contains a new or changed environmental standard not yet approved by the financial statement date. When the new legislation is approved, it will result in the future sacrifice of economic benefits.
- .15 PSAB has concluded that new legislation enacted after the financial statement date that may change or result in adoption of a new environmental standard, regardless of effective date, does not create a liability at the financial reporting date even though contamination that exceeds the changed or new environmental standard existed at the financial reporting date. This is a new liability that would be recognized in the period in which the legislation changed. This is consistent with LIABILITIES, paragraph PS 3200.27, that states "Legislation having retroactive application cannot create a past obligating transaction or event. Any obligations related to such legislation would be accounted for in the current period, not in the period of the effective date of the legislation."
- .16 When legislation is enacted in the stub period between the financial reporting date and preparation of financial statements, reference would be made to SUBSEQUENT EVENTS, Section PS 2400, to determine whether an adjustment of estimates should be made or disclosure is necessary.

Uncertainty about existence and responsibility

- .17 There were a number of issues raised by respondents with respect to uncertainty; namely, uncertainty about the existence of contamination, uncertainty about government responsibility and uncertainty about the measure of a liability. Measurement uncertainty has been dealt with under the separate heading "Measurement" below.
- .18 Recognition of a liability when the government is responsible, but there is uncertainty about the existence of contamination, would require the exercise of professional judgment in determining the probability that future site investigations would confirm the existence of contamination. It would be based on all information available about a particular site or group of sites including similarities to and experience at other known contaminated sites.

- .19 If, based on information available, it is likely that future site investigations will confirm contamination, a liability would be recognized if the amount can be reasonably estimated. Uncertainty about the nature and extent of contamination would be considered in the estimate of the liability.
- .20 Uncertainty about whether a government is responsible is a different matter, as it relates to whether the government has a present obligation. This type of uncertainty characterizes a contingent liability. The existence of contamination that exceeds an environmental standard is an existing condition or situation. A decision, by a regulator or court, that a government is responsible is not wholly within the government's control. The resolution of the uncertainty confirms the incurrence or non-incurrence of a liability. This situation requires an assessment of the probability that the outcome will confirm responsibility and should be assessed in accordance with CONTINGENT LIABILITIES, Section PS 3300.

Measurement

- .21 The SOP proposed that the estimate of a liability represents the sum of the discounted future cash flows associated with remediation activities. In periods subsequent to initial measurement, a government shall recognize changes in the liability resulting from:
- (a) revisions to the timing or the amount of the estimate of undiscounted cash flows;
 - (b) adjustment of the discount rate used; and
 - (c) interest expense.
- .22 The majority of respondents agreed that a net present value technique was appropriate in measuring long-term liabilities and consistent with other PSA Handbook standards. However, some respondents felt that the standard should not be prescriptive of the measurement technique. Those disagreeing questioned the reliability of an estimate based on net present value given the uncertainty about both the amount and timing of future cash flows that can be inherent in remediation of contaminated sites. The reliability of the estimate of future cash flows depends on the extent and complexity of contamination, site characteristics, technology available, and time frame over which remediation will occur.
- .23 The best estimate is the amount at which the liability could be settled or transferred to a third party at the financial statement date in a current transaction between willing parties (i.e., other than in a forced or liquidation transaction). Quoted market prices in active markets are the best evidence for measurement, when available. When quoted market prices are not available, the estimate of the liability is based on the best information available in the circumstances, including prices for similar liabilities and the results of present value or other valuation techniques.
- .24 When the cash flows required to settle a liability are expected to occur over extended future periods, a present value technique is often the best available technique with which to estimate the measure of a liability.

Transitional provisions

.25 One respondent commented that on initial adoption of this standard, jurisdictions will be required to complete a significant number of site investigations to determine whether they have a liability and, if so, its nature and extent. PSAB proposes an extended transition date to allow governments to complete the assessment work.