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Hazardous Wastes Disposal Costs

Their Recognition is a Social Responsibility of the Independent Auditor

By Gary Saunders and Roland L. Madison

Dioxin is only the latest hazardous waste material to gain national attention because of inadequate disposal methods. Before dioxin, PCBs, TCE, Kepone, arsenic, lead, and a number of other toxic or carcinogenic waste products commanded the nation's attention. Concern about the hazards of waste dump sites and their requisite cleanup has thrust relatively obscure locations, such as Love Canal, Times Beach, and Midland, into national prominence and has been responsible, at least in part, for the recent resignations of two high-level Environmental Protection Agency (EPA) officials.

Estimates have placed the number of hazardous waste sites in the United States as high as 51,000. The EPA indicated that some 57 million tons of hazardous wastes were being generated annually and approximately 90 percent of those wastes were being disposed of in an environmentally unsafe manner. Potential liabilities for firms generating and disposing of the waste material are staggering. One SEC accountant recently surmised that the potential liability for cleanup of the existing dump sites was in the "megabuck" range. Based on the pervasiveness of the problem, estimates

as high as \$500 billion are not unreasonable.

To date, the independent auditor has not been a central figure in the controversy. However, it is quite conceivable that audit firms will become embroiled in the economic controversy as the full cost of the effort to rectify the problem becomes more apparent. The jury is still out on the question of who will bear the expense. If resolution of the question results in requiring firms that generate such hazardous waste materials to pay even a portion of the cleanup cost, the impact on the financial position of those firms may be substantial. A consideration of the independent auditor's role in the disposition of hazardous waste material yields some interesting possibilities.

Current Treatment of Disposal Costs

Immediate costs associated with the disposal of hazardous wastes are recognized in the determination of current income in accordance with generally accepted accounting principles (GAAP). Any future costs incurred as a result of present disposals should be considered within provisions

of Statement of Financial Accounting Standards No. 5 "Accounting for Contingencies (1975)." SFAS No. 5 indicates in paragraph 8 that:

An estimated loss from a loss contingency...shall be accrued by a charge to income if *both* of the following conditions are met:

- a) Information available prior to issuance of the financial statements indicates that it is probable that ... a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b) The amount of the loss can be reasonably estimated.

The Statement further describes three points on a continuum relating to the probability that a liability has been incurred as:

- a) *Probable*. The future event or events are likely to occur.
- b) *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
- c) *Remote*. The chance of the future event or events occurring is slight.

In the event that one or both of the conditions specified in paragraph 8 are not met, but there is at least a "reasonable possibility" that a loss resulting in the impairment of an asset or the incurrence of a liability may have occurred, the contingency should be handled through disclosure. Contingent liabilities should not be disclosed, except in special circumstances, when their possibility of occurrence is remote.

Since chemical processes tend to be prolific generators of hazardous wastes, a perusal of the annual reports distributed by four large chemical companies revealed that over the last half-dozen years, contingent liabilities arising from the current disposal of hazardous waste materials were disclosed in notes to financial statements. Understandably, the disclosures took on optimistic stance and typically included indications that resolution of the contingent liabilities would not materially affect the financial position or results of operations for the firms.

Two exceptions to the ordinary footnote disclosure merit comment. Annual reports of the Occidental Petroleum Corporation for the 1980 and 1981 fiscal years, disclosed contingent liabilities without a monetary assessment in the balance sheet with footnote references. That approach, in conjunction with the typical footnote disclosure, tends to place somewhat more emphasis on significant contingent liabilities. Audit opinions on Allied Corporation's statements for the 1977 and 1978 fiscal years were "qualified" because of the significance of the contingent liabilities. However, a close reading of the footnote indicates that contingent liabilities relating to hazardous waste disposal were not substantially responsible for the qualifications but they were a contributing factor. Other contingent liabilities arising from business ventures appear to have been a major influence in arriving at the decision to qualify the opinions on Allied's financial statements.

There appears to be one common criterion currently used in the recognition and subsequent disclosure of contingent liabilities in the financial statements examined. This criterion relates to the three points on the probability distribution discussed in SFAS No. 5. For the occurrence of an event giving rise to a contingent liability to be considered "reasonably possible," auditors apparently look for an asserted claim or assessment, i.e., a lawsuit or regulatory action. That procedure is, on the surface, consistent with a provision of SFAS No. 5 which states that:

Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim of assessment... (p.5).

Consequently, the assertion of a claim or assessment serves as an indication that a contingent liability should be recognized at least through disclosure. The same sentence continues by implying that a contingent liability should be disclosed when:

...it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

Most liabilities presently recognized in the financial statement stem from

legally enforceable obligations that are based upon contracts and exchange transactions. However, the Board extended the definition conceptually to include obligations that:

...stem from ethical or moral constraints rather than rules of common or statute law, that is, from a duty to another entity to do that which an ordinary conscience and sense of justice would deem fair, just, and right — to do what one ought to do, rather than what one is legally required to do. (*Statement of Financial Accounting Concepts* No. 3, 1980, p. 15).

Certain noncontributory pension plans that are maintained without contracts and compensated absences paid to employees without mandatory vesting provisions demonstrate the application of the conceptually broader social view of a liability (*Statement of Financial Accounting Standards* No. 43, 1980). These examples, and the preceding citations from SFAS No. 5 and SFAC No. 3 show that it may be quite appropriate to recognize some contingent liabilities before a lawsuit is filed or a regulatory body initiates action against a firm.

Need For More Rigorous Interpretation of SFAS No. 5

When the Hooker Chemical Corporation, a subsidiary of Occidental, disposed of industrial wastes at the Love Canal site during the 1940s, there was little reason to suspect that very significant future liabilities would arise. "Carcinogenic" was not the frequently used term that it is today. Recognition of a contingent liability stemming from the disposal probably received minimal consideration.

Hooker officials apparently recognized the possibility of disaster when they twice issued strong public warnings about potential health hazards in 1957. The Niagara Falls Board of Education, using the threat of eminent domain, purchased the property for one dollar in 1953, and was considering the sale of parcels to private developers. Nonetheless, Occidental (Hooker's parent company) very reluctantly disclosed contingent liabilities resulting from the disposal of hazardous wastes. In fact, the company was charged by the Securities and Exchange Commission in 1980 with failure to disclose hundreds of millions of dollars in potential liabilities stem-

ming from waste disposals at the site. Further, the SEC said that Occidental should have disclosed the potential exposure and costs associated with claims resulting from operations related to the environment.

It is apparent that society in general and users of financial statements in particular cannot expect companies that generate and dispose of hazardous waste materials to vigorously pursue full disclosure of resultant contingent liabilities in their financial statements. The obvious advocate for society and financial statement users in the matter is the independent auditor. A more rigorous interpretation of SFAS No. 5 by the independent auditor accompanied by more aggressive inquiries of management and their legal council would undoubtedly result in more comprehensive disclosures. The situation, particularly with respect to the public's level of environmental awareness, is substantially different than it was several decades ago and the public accounting profession owes society and the financial community no less than full disclosure of the massive potential liabilities connected with the environmentally unsafe disposal of hazardous wastes.

Another aspect of the problem is the short-run tactical decision model that most industries have apparently been using in making determinations about the disposal methods to be used for hazardous wastes. The Chemical Manufacturers Association estimates that the cost of using landfills for hazardous waste disposal — a method typically considered environmentally unsafe — is \$25 per barrel. At the same time, it estimates the cost for incineration of hazardous wastes, which is recognized as a more environmentally safe method of disposal, to be slightly more than \$100 per barrel. (*Time*, March 29, 1982). Obviously, a short-term decision model, based only on initial disposal costs, would dysfunctionally indicate the landfill disposal method as preferable.

A longer-run decision model which considers all of the long-range costs of disposal, including eventual cleanup costs, would probably lead to more economic decisions, i.e. disposal of hazardous wastes by a more environmentally safe method. With respect to the total costs of disposal, the EPA estimates that the monies

already expended at Love Canal through mid-1980 for cleanup of wastes are an astounding fifty-four times the amount that would have been required to dispose of them initially by an environmentally safe method. (*New York Times*, June 8, 1980). A more rigorous interpretation of SFAS No. 5, resulting in pressures to disclose the huge contingent liabilities at the time of disposal, might well cause firms to re-evaluate their disposal decisions and methodologies which hopefully will result in the adoption of more environmentally safe disposal methods.

When examining current developments, it may be more appropriate to consider the incurrence of a future liability (cleanup costs) as being "probable" and either accrue to current income or, at a minimum, disclose the very real contingent liability involved with environmentally unsafe disposal of hazardous wastes. Some settlements, involving the payment of millions of dollars, have already been made by companies in matters relating to past disposals. It is very unlikely that the liability insurance requirements, imposed by the EPA on companies that dispose of hazardous wastes, will be sufficient to cover the eventual costs associated with materials disposed of in an environmentally unsafe manner. The EPA's \$1.6 billion "superfund" offers little assistance

since it was established to finance the cleanup of abandoned dump sites when their owners could not be located. When owners can be found, EPA's plan calls for requiring them to pay cleanup costs for the sites or face prosecution. The Justice Department brought felony charges before 25 grand juries in 14 states against individuals accused of illegally dumping hazardous wastes. Earlier this year, two businessmen in a large midwestern metropolitan area were sentenced for illegally disposing of soil contaminated with PCBs (*Akron-Beacon Journal*, February 14, 1984). Consequently, the incurrence of a future liability resulting from the environmentally unsafe disposal of hazardous wastes is now more likely "probable" than "remote." Independent auditors should recognize that fact and press for recognition of those contingent liabilities particularly when considering the social and moral aspect for liability recognition as previously discussed in SFAC No. 3.

Summary

It is becoming evident that the costs to eliminate just the hazardous waste dump sites currently identified will be enormous and that total liabilities for past and future environmentally unsafe disposals could very well threaten the existence of several companies. As Polkowski observed, "Love Canal is

only the tip of the iceberg... To date, industry, the general public, and Federal, State, and local governments have not confronted the totality of the waste problem facing our country." (*GAO Review*, Summer, 1981).

The need for earlier recognition and fuller disclosure of contingent liabilities accruing from the environmentally unsafe disposal of hazardous wastes may represent a unique opportunity for the public accounting profession to further justify the trust placed in it by society. Authority to require earlier recognition is apparently existent in terms of generally accepted accounting principles in SFAS No. 5, and conceptually reinforced from SFAC No. 3 from a socially expected viewpoint. Given the trend of current events toward increased corporate social accountability, a more rigorous interpretative stance by the accounting profession should generate strong support for a proposal of earlier liability recognition in the financial statements.

Audit firms have been typified as "deep pockets" because of the number and size of litigation settlements arising from losses suffered by their clients' creditors and stockholders. Earlier recognition of contingent liabilities would almost certainly reduce the audit risk exposure of public accounting firms, thereby mitigating the effort required in convincing clients of the necessity for earlier disclosure. Ω



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