Subtitle C and D Corporate Financial Test Analysis
Issue Paper
Accounting Issues Affecting the Corporate Financial Test

Background and Purpose

The Subtitle D financial responsibility requirements allow owners and operators to use a financial test to assure costs of closure, post-closure, or corrective action associated with municipal solid waste landfills. On October 12, 1994, the Agency proposed financial criteria and a set of procedures with which owners and operators must comply to use the financial test.

To be eligible for the financial test, owners and operators must have a minimum net worth of $10 million. The need for a minimum net worth requirement was supported by the Agency's analysis. The Agency found significantly higher bankruptcy rates for firms with a net worth less than $10 million. In addition to this requirement, owners and operators must satisfy additional requirements with regards to financial ratios, bond ratings, net worth, and assets.

The financial test, for the most part, relies on information contained in a firm's audited financial statements. In the proposed Subtitle D financial test rule, however, the Agency has allowed firms some flexibility with respect to a recent accounting rule, FASB 106. FASB 106 is an accounting standard issued by the Financial Accounting Standards Board (FASB) in December, 1990. This standard requires companies to record the estimated cost of other post-employment benefits (OPEBs), other than pensions, for all fiscal years beginning after December 15, 1992.[1] Under FASB 106, companies are allowed to recognize their OPEB liabilities in one of two ways: immediate recognition, or delayed recognition, whereby OPEBs can be amortized over 20 years or the average remaining service years of employees. Those companies that opted for immediate recognition had to record their entire OPEB liabilities on their balance sheet in the first year of adoption and, consequently, felt an average reduction in net worth of 10-15 percent. In response to previous comments and to level the playing field between companies, EPA proposed to allow companies to use delayed recognition for purposes of the financial test *regardless* of the recognition method they used in their financial statements.

Under the recordkeeping and reporting requirements of the proposed rule, the owner or operator must place certain items in the facility's operating records. Included in these items is a special report from the firm's independent certified public accountant to the owner or operator. In this special report, the auditor verifies that the data used by the chief financial officer of the firm in the financial test are derived from the firm's audited financial statements. In addition, the auditor must state that "in connection with that examination," no matters came to his attention that caused him to believe that the data used by the chief financial officer should be adjusted. The auditor's special report essentially validates the financial data used by the firm to pass the financial test.

[1] Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 106, Financial Accounting Series: No. 098-D, December 1990.

Audited financial statements include an opinion from an independent auditor indicating whether the financial statement data correctly represent the financial condition of the firm. An auditor expresses one of four types of opinions on a firm's financial statements:

(1) Unqualified or "clean" opinion, expressing no doubt;
(2) Qualified opinion;
(3) Disclaimer of opinion; and
(4) Adverse opinion.

Firms that receive unqualified opinions are eligible to use the financial test. Firms receiving an adverse opinion or a disclaimer of opinion will be disallowed from using the test. In the case of a qualified opinion, however, the Agency felt it was appropriate to give states the option to review the opinion. The proposed Subtitle D financial test rule states that,

> "The Director of an approved State may evaluate qualified opinions on a case-by-case basis and allow use of the financial test in cases where the Director deems that the matters which form the basis for the qualification are insufficient to warrant disallowance of the test."

Finally, the Subtitle D corporate financial test regulations require firms to place all documentation supporting use of the test in the facility's operating record within 90 days of the end of their fiscal year.

This paper addresses concerns raised by commenters on accounting issues that could affect the financial test. The key issues raised by commenters are as follows:

- The Agency should specify procedures for companies to follow if they use a different method in the financial test than in their financial statements to account for their obligations under FASB 106;

- Net worth is not an appropriate measure of size because the inherent flexibility of Generally Accepted Accounting Principles (GAAP) could result in similar firms having different net worth;

- The proposed language describing procedures required of accountants in preparing the special report uses the word "examination" and the phrase "no matters came to his attention," which connote a different level of review in accounting circles than EPA intended;

- EPA should specify procedures for State RCRA program directors to use when evaluating a "qualified" opinion from an accountant; and

- The 90-day deadline for submitting financial test documentation is not sufficient for privately-held companies.

ICF has researched and analyzed each of these issues, and has addressed them in this paper. Our findings are based on published sources as well as conversations with the

American Institute of Certified Public Accountants (AICPA). The references are listed at the end of this issue paper.

Of the concerns described above, this paper suggests that the following may be appropriate for further Agency action:

- Specifying procedures for companies to follow with respect to accounting for FASB 106 in the financial test;

- Revising the language describing the activities that accountants must conduct to prepare the special report;

- Specifying circumstances under which State program directors should accept qualified opinions; and

- Determining if the deadline for submitting annual financial test documentation needs to be extended.

With regard to the appropriateness of using net worth as a measure of size in the financial test, our analysis (presented below) suggests that the flexibility in GAAP has no significant impact on the use of net worth as an effective measure of size.

This paper is organized into five sections. Section 1 discusses procedures that companies could follow in the financial test with respect to FASB 106. Section 2 analyzes the impact of the flexibility in GAAP on the net worth requirement of the financial test. Section 3 discusses the language concerns regarding an accountant's role in the financial test. Section 4 addresses the need to clarify the circumstances in which a RCRA state program director should accept a qualified opinion. Finally, Section 5 examines whether the present 90-day deadline for submitting financial test documentation is sufficient for privately-held companies.

1. Recognition of FASB 106

In the proposed Subtitle D corporate financial test rule, the Agency had proposed to allow companies to use delayed recognition of OPEBs for purposes of the financial test regardless of the recognition method they used in their financial statements. The Agency allowed this flexibility because several commenters on the proposed Subtitle C financial test regulation had argued that FASB 106 could significantly decrease the net worth of companies that used immediate recognition and adversely affect their ability to pass the test. The Agency, however, did not specify any procedures for companies to use that accountants could verify.

In its comments on the proposed rule, the American Institute of Certified Public Accountants (AICPA) expressed concern that the proposed rule had not specified any procedures for companies to follow if they used the delayed recognition method for OPEBs in the financial test, while using the immediate recognition method in their financial statements. Without such procedures, it would be difficult for the accountant responsible for the special report to verify that a firm is using the appropriate data in its financial test submission.

FASB has stated the following methods are acceptable for companies that opt for delayed recognition under FASB 106:[2]

"If delayed recognition is elected, the transition obligation or asset shall be amortized on a straight-line basis over the average remaining service period of active plan participants, . . . if the average remaining service period is less than 20 years, the employer may elect to use a 20-year period . . . "

The simplest option authorized by FASB allows companies to amortize their OPEB liabilities over a 20-year period on a straight line basis. To avoid ambiguity, the Agency may want to specify that companies using a different method in the financial test than in their financial statement should use a 20-year amortization period. Therefore, such companies would recognize 1/20th of their total OPEB liabilities every year in a cumulative manner (beginning from the first year in which they adopted FASB 106). Using this method, companies would have to recognize 1/20th of their OPEB liability for financial test purposes in the first year of adoption, 2/20th in the second year, and so on. This approach levels the playing field between companies that use different recognition methods and has the advantage of being easy to implement. ICF's conversations with the AICPA indicated that this approach would not be difficult for accountants to verify as long as it is explicitly stated in the financial test rule.[3]

To accommodate this change, the language in the proposed rule regarding the auditor's special report could be modified to include the underlined statements below:

"(C) ... a special report from the owner's or operator's independent certified public accountant to the owner or operator is required stating that:

(1) He has compared data in the chief financial officer's letter derived from the independently audited, year-end financial statements for the latest fiscal year with the amounts in such financial statements.

(2) <u>In addition he has:</u>

<u>(i) Verified that the owner or operator has used the same recognition method with respect to FASB 106 in the financial test as in the financial statements; or</u>

<u>(ii) In the case of an owner or operator that is using the immediate recognition method in the financial statements and a delayed recognition method in the financial test, verified that the owner or operator is amortizing the OPEB liabilities on a straight line basis over 20 years and recognizing them in a cumulative manner for purposes of the financial test, starting from the first year in which they adopted FASB 106."</u>

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[2] <u>Statement of Financial Accounting Standards No. 106</u>, December 1990.

[3] ICF telephone conversation on April 6, 1995 with Mr. Ian Mackay, CPA, Director of the Federal Government Division, American Institute of Certified Public Accountants.

2. The Impact of GAAP's Flexibility on Net Worth as a Measure of Size in the Financial Test

One commenter questioned the appropriateness of using tangible net worth as a measure of size given the flexibility allowed under GAAP. The commenter stated that because of this flexibility, firms of the same size with similar market opportunities, risks, and profitability may have very different tangible net worth.

Although firms are allowed some flexibility in financial reporting, the process of setting accounting principles under FASB has some noteworthy attributes. One important attribute is FASB's "effort to relate specific accounting Standards to more general-purpose financial statement objectives . . ."[4] One of these explicit objectives is that "financial reporting should provide information about the economic resources of an enterprise, [and] claims on those resources . . ."[5] The statement of financial position, or balance sheet, is the financial statement that provides this information. The balance sheet reports year-end assets (financial resources), liabilities (claims on those resources), and net worth (assets minus liabilities, or net financial resources). Therefore, in spite of the limited flexibility in financial reporting, all accounting standards are designed to ensure that net worth is a meaningful and useful measure of a firm's net financial resources.

The limited flexibility allowed by financial reporting can be classified into three groups:[6]

(1) Instances where the specific conditions associated with a transaction or event dictate the method of accounting that must be used, such as in the case of investments by a company. In such cases, a company does not have a choice as to the financial reporting method that must be used.

(2) Instances where a firm has wide flexibility in selecting accounting principles for purposes of preparing its income tax return but limited flexibility in selecting methods for its financial statements. Such cases do not affect the calculation of net worth for the financial test because the test is based on financial reporting, not income tax reporting.

(3) Instances where a firm has wide flexibility in choosing among alternative methods. A noteworthy example in this category is depreciation, where firms can use a straight-line method to depreciate their assets or one of many accelerated depreciation methods. Further, firms are allowed to use one method of depreciation for financial reporting and another for income tax reporting. Another example is inventory valuation. In the case of inventory valuation, however, a firm must use the same method for purposes of income

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[4] Davidson, S., C.P. Stickney, and R.L. Weil, Financial Accounting, An Introduction to Concepts, Methods, and Uses, Third Edition, 1982, p. 18.

[5] Davidson, et. al., p. 3.

[6] This information has been taken from Davidson, et. al., p. 577.

tax reporting as it does for financial reporting. A firm could not change its inventory valuation method in its financial reporting (e.g., for financial test purposes) without facing the consequences of its actions in income tax reporting.

Therefore, the primary area where a firm has wide latitude in financial reporting that can affect its net worth is depreciation. The impact of this flexibility on net worth, however, would be negligible because net worth is a cumulative measure of net financial resources acquired over the life of a firm. Depreciation is charged over the useful life of an asset, and the total amount charged would be the same irrespective of the method used -- i.e., 100 percent of cost minus salvage value, if any. Even in the short-run, the net impact of different depreciation methods on net worth may be negligible because different assets are at different stages of their useful life. Accelerated methods of depreciation recognize more expense that the straight-line method in the early years of an asset's life, but less in later years. At any given point in time, a large company can be expected to have many depreciable assets in the early stages of their lives and many others in later stages. Therefore, the net difference between the amount of depreciation charged between two companies using different methods should be insignificant -- one company may be charging more depreciation on some assets than the second company, but less on other assets. Consequently, the remaining value of assets displayed on the balance sheet that affects the calculation of net worth should be comparable.

The above discussion suggests that net worth should be a reliable indicator of firms' net resources. Furthermore, the Agency's financial test analysis concluded that net worth, as reported in financial statements, is a significant determinant of whether a firm has sufficient net resources to ensure against bankruptcy due to economic downturns or other adverse conditions. Firm failure rates were found to decrease as firms increase in size, as measured by their net worth. This range of estimated annual failure rates for different size firms for the period 1984 through 1990 is provided in Exhibit 1 below. As shown in the exhibit, the failure rate decreases significantly as net worth increases.

Exhibit 1
Estimated Firm Failure Rates

Net Worth ($ million)	Failure Rate (%)
0-10	1.53
10-20	1.24
20-100	1.02
100-400	0.81
400-1 billion	0.55
> 1 billion	0.14

Finally, in addition to evidence that net worth is a reliable indicator of financial strength, it should be noted that a reliance on reported net worth minimizes the Agency's administrative burden and ensures the relevance of the financial test analysis, which was based on reported net worth.

The one situation in which the proposed rule allows firms to depart from financial reporting is with respect to FASB 106. As discussed above, the Agency made this one exception to create uniformity between companies with regards to accounting standards for two reasons. First, FASB 106 can significantly decrease net worth. In the case of companies that opted for immediate recognition, the one-time charge has been estimated to decrease net worth by 10-15 percent.[7] The impact of this rule on firms' net worth was widely discussed in the financial press and the Agency received several comments on FASB 106 when the Subtitle C financial test rule was proposed. Therefore, in the Subtitle D rule, the Agency proposed to level the playing field between companies that opt for immediate recognition and those that opt for delayed recognition. Second, the data used in the financial test analysis and in selecting the least cost test, did not incorporate the effects of FASB 106. Consequently, if the Agency did not create uniformity between companies, some financially strong firms could needlessly fail the test simply because they adopted the immediate recognition method in their financial statements when accounting for FASB 106.

Even this one departure from financial reporting allowed in the proposed rule has raised questions about specific guidance and procedures for implementation. Any other departures would add a significant amount of complexity to the financial test. Further, as stated above, the Agency's analysis of public and private costs reflects reported financial data, including any effects of limited flexibility, and the proposed test was selected based on this data. Any departures from reported data could undermine the applicability of the Agency's financial test analysis.

3. Language Concerns Regarding the Auditor's Special Report

The AICPA raised several concerns over the language in the proposed rule that specified the procedures that accountants were to use in preparing the special report, which is a required element in the corporate financial test. The proposed rule requires accountants preparing the special report to state that:

> "In connection with that examination, no matters came to his attention which caused him to believe that the data . . . should be adjusted."

According to the AICPA, the word "examination," appears to connote a higher level of review in accounting circles than the activities EPA intended for accountants to conduct. AICPA further stated that the phrase "no matters came to his attention which caused him to believe that the data . . . should be adjusted," indicates negative assurance as provided by a "review-level engagement," which again is not appropriate to achieve the procedure sought by EPA.

AICPA's comment on the corporate financial test indicated that, for purposes of the special report, the term *examination* should be avoided because an examination would be

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[7] Kann, R.H., and D.E. Turner, "Reassessing Retiree Benefits: The New Challenge," Employee Benefits Journal, Vol. 18, No. 1, March 1993, pp. 21-25.

neither appropriate nor what EPA intended. AICPA's comment also recommended against the use of negative assurance due to the trend away from that type of engagement, as explained below. Instead, the comment suggested that EPA specify the use of an *agreed-upon procedures engagement*, described below, unless EPA is indeed seeking opinion-level assurances, in which case it should require *examinations*.

ICF contacted the AICPA to seek clarification on what the different accounting terminologies mean. The information presented below is based on a telephone conversation with Mr. Joseph Moraglio of the AICPA.[8]

Mr. Moraglio confirmed that an auditor may conduct any of three levels of review to provide assurance with regards to the validity of financial data. The highest level of engagement (the review level that provides the greatest amount of assurance) is the *examination*. Alternatives to the examination include the *review-level engagement* and the *agreed-upon procedures engagement*. Each of these levels of review is described below.

- **Examination.** The use of the term *examination* implies that the auditor has done enough work to express an opinion. In performing an examination, the auditor must exercise judgment in determining the procedures and level of effort required for the examination. The auditor states an opinion based on the results of his/her analysis. An examination-level engagement provides the highest level of assurance.

- **Review-level engagement.** This type of engagement involves less effort and provides less assurance than the *examination*. For this reason, the auditor always states the findings of a review-level engagement in the form of negative assurance (e.g., "Nothing came to our attention to indicate. . ."). Accountants have been gradually phasing out the use of this type of engagement due to the confusion that users of reports may have with that level of assurance.[9]

- **Agreed-upon procedures engagement.** Under an *agreed-upon procedures engagement*, the auditor simply carries out procedures specified by another party, which in the case of the financial test would be the facility owner or operator. Therefore, the party that specifies the procedures takes responsibility for their adequacy and for the level of assurance they provide. In an *agreed-upon procedures engagement*, the auditor does not express an opinion; instead, he/she states what procedures were performed, what the findings were, and leaves any

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[8] ICF telephone conversation on March 22, 1995, with Mr. Joseph Moraglio, CPA, Vice President - Federal Government, American Institute of Certified Public Accountants, 1455 Pennsylvania Ave., NW, Washington, DC 20004-1081. Mr. Moraglio authored AICPA's comment on the proposed corporate financial test, and is a certified public accountant and AICPA Vice President (Federal Government) with over 15 years experience developing accounting standards.

[9] The review-level engagement is generally prohibited for attestations involving compliance with rules and regulations.

judgments to the reader. For example, the auditor might compare two sets of numbers, and state that he/she "found them to be in agreement." In the financial test context in particular, such a statement indicates that the auditor is not expressing an opinion on the validity of the data contained in the financial statements themselves.

Based on the description of review levels provided above, the Agency could adopt The AICPA's suggestion of use of the term *agreed-upon procedures engagement*. This terminology should suffice for the special report, because the purpose of the special report is to determine that the data used in the financial test are in agreement with the data in audited financial statements. As discussed in the example above, an *agreed-upon procedures engagement* might be a comparison of two sets of numbers. A higher level of review, such as an *examination*, is not needed because the financial statements have already been reviewed by an independent auditor.

In light of our findings, the Agency may wish to re-write the language in the proposed rule regarding the auditor's special report as follows:

> "(C) ... a special report from the owner's or operator's independent certified public accountant to the owner or operator is required stating that <u>he had performed an agreed-upon procedures engagement and that</u>:
>
> > (1) He has compared the data ..., <u>and found the two sets of numbers to be in agreement</u>."

As part of this re-write, the following statement in the proposed rule would have to be deleted:

> "(2) In connection with that examination, no matters came to his attention which caused him to believe that the data in the chief financial officer's letter should be adjusted."

4. Evaluation of Qualified Opinions from Accountants

The Agency proposed that companies that have received unqualified opinions from independent auditors on their financial statements be eligible to use the test. The proposed rule, however, also allowed RCRA State program directors to determine whether companies that had received a "qualified" opinion from their auditor were eligible to use the financial test. One commenter suggested that EPA should specify procedures for State directors to use when evaluating a qualified opinion.

ICF's research indicates that most auditors' opinions are unqualified.[10] This finding was substantiated by Mr. Mackay of the AICPA, who stated that the vast majority of opinions are unqualified, at least in the final opinion issued (i.e., any problems are resolved by the company and the accountant before the opinion is finalized). Therefore, in most cases, there is no ambiguity regarding auditor's opinions.

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[10] Stickney, C.P., R.L. Weil, and S. Davidson, <u>Financial Accounting, An Introduction to Concepts, Methods, and Uses</u>, Sixth Edition, 1991, p. 17.

ICF was unable to find any past Agency analysis identifying what types of qualified opinions should be accepted or rejected. In reality, evaluation of a qualified opinion could be a fairly complicated procedure. Situations in which an auditor issues a qualified opinion could arise for a number of reasons, including ". . . material uncertainties regarding realization or valuation of assets, outstanding litigation or tax liabilities, or accounting inconsistencies between periods caused by changes in the application of accounting principles."[11] Accounting inconsistencies, for example, could suggest that the data in the firm's financial statements don't accurately reflect its financial position. Qualified opinions that raise doubts about whether a company can stay in business or which adversely reflect on a company's financial strength, should not be accepted for purposes of the financial test. The Agency may wish to specify that State RCRA program directors should reject such qualified opinions except in very rare cases where a company can demonstrate that the qualification has no bearing on the firm's ability to pass the test. This change could be accomplished by modifying the language in the proposed rule to include the underlined statements below:

> "The Director of an approved State may evaluate qualified opinions on a case-by-case basis and allow use of the financial test in cases where the Director deems that the matters which form the basis for the qualification are insufficient to warrant disallowance of the test. <u>Directors should not accept qualified opinions with 'going concern' implications that raise doubts on whether a company can stay in business. Further, Directors should accept qualified opinions only if a company can show that it would still pass the financial test irrespective of the outcome of the event or correction of accounting inconsistency with which the qualification in opinion is associated.</u>"

In addition, the Agency could provide specific examples in the preamble to the rule, such as the following:

> "For example, if a company could stand to lose half its net worth if it lost a lawsuit, it must demonstrate that it would still have adequate net worth to pass the financial test."

Alternatively, the Agency may want to reconsider allowing State program directors to evaluate qualified opinions at all. First, there is a risk associated with allowing firms with qualified opinions to use the financial test because the data in their financial statements that they use to pass the test may not accurately reflect their financial strength. Second, because the overwhelming majority of opinions are unqualified, allowing State directors to evaluate qualified opinions would benefit very few firms. Finally, States would incur administrative costs to evaluate qualified opinions. In fact, some States in their comments on the proposed Subtitle D corporate financial test as well as on the local government financial test have indicated that only unqualified opinions should be allowed, and that State directors should not be allowed to evaluate qualified opinions. In its comments, the National League of Cities has stated that, "it would be our position that the State Director not be put in the potentially untenable, if not highly political, position of making these kinds of judgements [sic]." Further, the Texas Natural Resource Conservation Commission in its comments has stated that, "allowing qualified

[11] Stickney, C.P., et. al., p. 17.

opinions to be reviewed by each State Director places too much financial analysis burden on the States."

Given the potential risks, low benefits, and administrative costs associated with allowing qualified opinions, the Agency may want to consider allowing only unqualified opinions in the financial test. The Agency could also contact States and EPA Regions to obtain additional information before making its final decision on this matter.

5. Deadline for Financial Test Submission

The proposed rule requires owners or operators using the financial test to place the financial test documentation in the facility's operating record within 90 days of the end of their fiscal year. Private companies were concerned that they could not meet this requirement because publicly-held companies must file financial reports with the SEC in the same time frame and, consequently, demand the majority of accountants' time. Therefore, private companies argued that they could not get access to accountants in time to prepare the necessary documentation for the financial test.

The Agency's original rationale for the 90-day deadline was that it coincides with the SEC's deadline for documents that publicly-held companies must file.

The AICPA agreed that the commenters' concern was a valid one for companies whose financial year coincides with the calendar year, because January 1 through April 15 is the busiest season for accountants due to taxes, SEC reporting, FDIC reporting, and other federal reporting requirements.[12] In light of this fact, the Agency may want to consider extending the period for financial test submission to 120 days. Extending the deadline, however, has the disadvantage of allowing more time to elapse before a company realizes that it may not meet the requirements of the financial test and takes steps to obtain alternative financial assurance. Further, the issue may not be as significant as commenters contend. During the Agency's experience with the Subtitle C corporate financial test, which has in use for over 10 years, companies do not appear to have had significant difficulty in meeting the 90-day requirement. Before making a final decision on this matter, the Agency may wish to discuss the issue with EPA Regions and States to determine if the deadline has been a problem to date.

[12] ICF telephone conversation with Mr. Ian Mackay, AICPA.

REFERENCES

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