Subtitle C and D Corporate Financial Test Analysis
Issue Paper
Reporting Timeframes

Introduction

Firms using the financial test to determine financial assurance must meet certain recordkeeping and reporting requirements in addition to the technical requirements of the test itself. According to the Agency's proposed rule under Subtitle D, owners and operators using the financial test are required to place the proper documentation in the facility's operating record within 90 days of the end of the firm's fiscal year. Subtitle C owners and operators submit their documentation to the EPA or the State for review on the same schedule. This procedure must be followed annually to ensure that firms using the test continue to demonstrate their financial strength over time.

The first component of the documentation consists of a letter from the firm's Chief Financial Officer (CFO) listing all cost estimates covered by the test and providing evidence that the firm satisfies the financial criteria of the test. An unqualified, or "clean" opinion from an independent certified public accountant (CPA) comprises the second component. An owner or operator is denied use of the financial test if the accountant finds that the firm's financial statements have not been prepared according to the generally accepted accounting principles (GAAP) for corporations. Having audited financial statements is therefore critical for passing the financial test. If an owner or operator is not allowed to use the financial test, it must obtain an alternative mechanism within thirty days.

This issue paper analyzes the following two issues associated with financial test reporting timeframes:

- ♦ The extent to which audits are unavailable within 90 days following the close of private companies' fiscal years and whether auditors' reports can be obtained on an earlier schedule and at what cost.
- ♦ The amount of time needed to secure an alternative financial responsibility mechanism once it is determined that an owner or operator no longer passes the financial test or qualifies as a guarantor.

The key findings of this paper, in summary are:

- ♦ It may be difficult for facility owners or operators to obtain audited financial statements within 90 days. The Agency may therefore wish to extend the deadline for submitting annual financial test documentation to 120 days;
- ♦ The additional 30 days allowed for obtaining a third-party mechanism in the event that a firm fails the financial test appears sufficient for most owners and operators.

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1. Deadlines for Financial Test Submissions[1]

The Agency originally chose the 90-day deadline for filing financial test documentation because it coincides with the Security and Exchange Commission's (SEC's) deadline for documents that publicly-held companies must file. However, private firms have expressed concern that an accountant's opinion cannot be obtained within the designated time due to the heavy demand for accountants by publicly-held firms during that same time frame (most companies' fiscal years close on December 31.) They argue that the necessary documentation for the financial test cannot be prepared because they lack access to CPAs.

The American Institute of Certified Public Accountants (AICPA) agreed that the concern is valid for companies whose financial year closes with the end of the calendar year. Tax season, SEC reporting, FDIC reporting and other federal reporting requirements together make the period of January 1 through April 15 the busiest season for accountants.[2] The AICPA has also suggested that the timelines with which public accountants can respond to the demands of owners or operators depends very much upon the condition of the firm's financial statements. Compliance with the 90-day deadline is more likely if a firm's records are complete and in order, and made readily available to the accountant. Although an accurate estimate regarding the amount of time needed to perform an audit cannot be made due to variations in management and firm size, firms less willing to cooperate with auditors and whose financial histories are in a state of disarray may very well fail to obtain audited financial statements prior to the financial test deadline.[3] To avoid this, firms may opt for "rush" auditing, however, payments for overtime may make this route costly. Due to the wide variations in the costs of audits, ICF was unable to quantify this additional cost. The option of obtaining a rush audit is also constrained by the natural and human limitations of the CPA firm. During extremely busy times of the year, a given firm may be unable to take on additional work at any price.

In light of the situation described above, the Agency may want to consider lengthening the period for financial test submission to 120 days. Extending the deadline, however, creates the disadvantage of allowing more time to elapse before a firm recognizes its failure to meet requirements and takes the proper 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 that has been in use for over 10 years, companies do not appear to have encountered significant difficulty in meeting the 90-day deadline. Therefore, the Agency may wish to discuss the issue with EPA Regions and States to determine the extent of the problems posed to date by the deadline before making a final decision on the matter.

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[1] See also ICF Incorporated Issue Paper 4: Accounting Issues Affecting the Corporate Financial Test, July 14, 1995.

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

[3] ICF telephone conversation with Ms. Louise Williamson, AICPA.

2. Time Needed to Obtain a Third-Party Mechanism

Once a firm finds that it is no longer eligible for the financial test, the owner or operator must seek and obtain another means of financial assurance (i.e., in the form of a letter of Credit, trust fund or surety bond) within 120 days of the close of the firm's fiscal year (i.e., 30 days following the deadline for financial test submission). The Agency's rationale for this 120-day deadline is to ensure that there is no significant gap in financial assurance, while at the same time allowing firms that use the financial test sufficient time to obtain an alternative financial mechanism once they discover that they no longer pass the test. Commenters on the proposed financial tests suggested that firms that discover they fail the financial test at the end of the 90-day reporting period do not have enough time to find an alternative financial mechanism.

The primary factor affecting whether a firm that fails the financial test can obtain an alternative mechanism is the time required by the provider of the mechanism to process information and execute the necessary documentation. While the owner or operator will need time to fill out forms such as loan applications, the time involved should not prevent a firm from obtaining an alternative mechanism. Consequently, to determine whether an additional 30 days beyond the deadline for filing financial test documentation is sufficient to allow a firm to obtain an alternative mechanism, ICF contacted representatives in the banking and surety industries to determine whether letters or credit, trust funds, and surety bonds could be drafted and executed within 30 days. ICF did not analyze the time required to obtain an insurance policy because nearly no owners or operators use insurance policies supplied by an independent insurer (i.e., not a captive insurer) to comply with requirements.

A representative of the banking industry suggested that obtaining a letter of credit within 30 days is a viable option as long as the firm can provide the necessary financial information and audited financial statement are available. For firms that already maintain a working relationship with a bank, this task is greatly facilitated because the bank already has in its possession the necessary financial statements spanning several years as well as an understanding of the firm's current credit standing. On the other hand, a newer firm will most likely face greater difficulties because it is not yet established as a financially sound practice.[4]

Creating a trust fund should also be possible within a 30-day timeframe. Banks generally have the capacity to draw up the necessary documents quickly, although a representative of the banking industry suggested that delays may arise on the part of the firm.[5] To begin, the firm must determine which of its assets can be segregated and placed into the trust account. From a market-timing standpoint, owners or operators do not want to lose their investments and generally would want to negotiate the terms of asset transfers. The time needed to make the necessary decisions regarding assets and to complete negotiations will ultimately determine whether the trust fund can be set up within 30 days. It is important to note, however, that the delays that could occur in setting up a trust fund are in the control of the owner or operator and should not necessarily prevent the timely execution of a trust.

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[4] ICF telephone conversation with Denise Chamberlain, Mellon Bank: Pittsburgh.

[5] ICF telephone conversation with Denise Chamberlain, Mellon Bank: Pittsburgh.

Firms unable to meet the requirements of the financial test may also chose to obtain a surety bond. However, according to the Surety Association of America, the risky nature of these bonds makes them difficult to obtain for many firms.[6] To perform the underwriting analysis necessary for issuing the bond, surety dealers will generally require firms to submit three years of financial statements in addition to a profile of executives and stockholders. While firms that had established a previous working relationship with the surety have a good chance of obtaining surety bonds to satisfy the alternative financial assurance requirement, new firms will most likely be denied, especially due to the additional risks involved with environmental liabilities.

In summary, while there may be cases where the additional 30-day period provided to financial test users is too short to obtain an alternative mechanism, generally, it will be sufficient. Firms large enough to have been using the financial test options most likely have established banking relationships as well as adequate financial records that should facilitate their obtaining a third-party mechanism.

[6] ICF telephone conversation with Mr. William Kelly, Surety Association of America.