

SELECTED AREAS OF COST

Chapter 26 - Environmental Costs

Authoritative Sources

[FAR 31.201-2](#) Determining Allowability

[FAR 31.201-3](#) Determining Reasonableness

[FAR 31.201-4](#) Determining Allocability

[FAR 31.201-5](#) Credits

[FAR 31.205-3](#) Bad Debt

[FAR 31.205-7](#) Contingencies

[FAR 31.205-15](#) Fines, Penalties, and Mischarging Costs

[FAR 31.205-19](#) Insurance and Indemnification

[FAR 31.205-33](#) Professional and Consultant Service Costs

[FAR 31-205-47](#) Costs Related to Legal and Other Proceedings

This chapter addresses the following topics:

26-1 Summary

26-2 Types of Environmental Cost

26-3 Normal Business Expense and Environmental Costs

26-4 Reasonableness of Environmental Cost

26-5 Allocability of Environmental Cost

26-6 Environmental Cost Related to Previous Sites and Closed Segments

26-7 Capitalization of Environmental Cost

26-8 Potentially Responsible Party (PRP) for Environmental Clean-Up

26-9 Environmental Bad Debts of Other PRPs

26-10 Insurance Recovery for Environmental Cost

26-11 Fault-Based Liabilities to Third Parties

26-12 Environmental Wrongdoing

26-13 Nature of Environmental Cost

26-14 Advance Agreements for Environmental Cost

26-15 Environmental Clean-Up Trust Funds

26-1 Summary

Environmental costs may qualify as normal costs of doing business (e.g., environmental costs for compliance with existing laws and regulations in ongoing business operations and other preventive costs); however, auditors must analyze the costs to ensure they are allowable, allocable, and reasonable. If environmental clean-up costs resulted from contamination caused by contractor wrongdoing, the costs are not allowable. For example, clean-up costs are unallowable if the costs:

- resulted from a violation of contract terms per FAR 31.201-2(a)(4); or
- exceeded the amount that would have been incurred by a prudent person per FAR 31.201-3(a); or

- resulted from a contractor violation of its responsibilities to the public per FAR 31.201-3(b)(3).

Audit Considerations:

Under FAR 31.201-3(b)(2), when environmental clean-up efforts resulted from contamination caused by contractor wrongdoing, the clean-up costs are not allowable as those costs would not be the result of generally accepted sound business practices. If a contractor establishes that it complied with applicable laws, regulations, and permits in effect at the time of the contamination, the contractor may be permitted to recover the clean-up costs if they are allowable, allocable, and reasonable. Contractor wrongdoing may include failure to exercise reasonable care to avoid the contamination or failure to comply with the law. Environmental wrongdoing can occur without a formal citation or ruling by a government agency.

Environmental costs may be subject to future recoveries from insurance companies and other sources, which may not be reasonably predictable at the time the environmental clean-up costs are paid. Some of the sources of recovery may be unknown when the contractor pays environmental clean-up costs. As such, clean-up costs claimed or forecasted may not be reflective of the contractor's ultimate liability for the costs. If the contractor receives future recoveries from insurance policies or other sources, the Government should/is required to receive a cost reduction or a cash refund under FAR 31.201-5. For estimated environmental costs, the auditor should consider recommending an advance agreement to the Contracting Officer to protect the Government's interests in any future recoveries of clean-up costs under FAR 31.201-5.

26-2 Types of Environmental Cost

Environmental costs include costs to prevent environmental contamination, costs to clean up prior contamination, and costs directly associated with the first two categories including legal costs. Costs associated with the contractor's fault-based liabilities to third parties are not environmental costs (see 26-12).

26-3 Normal Business Expense and Environmental Costs

Normal business expenses are those expenses that a prudent businessperson would incur in the course of conducting a competitive for-profit enterprise. Not all normal business expenses are allowable for Government contract costing purposes. To be allowable, any cost, including environmental cost, must be reasonable in amount, allocable to Government contracts, and not be specifically unallowable under contract terms and Government cost principles.

Audit Considerations:

Since environmental contamination may result from contractor conduct dating back several years, the contractor's records concerning the site and operations are critical to the auditor's review of environmental costs. If an auditor becomes aware of a basis to question environmental cost, the auditor should immediately seek documentation from the contractor to support the claimed cost. The contractor should provide full and open access to its records concerning the site and its operations. The auditor can also obtain information from Government representatives (e.g., contracting officers, environmental attorneys, technical engineers, etc.).

26-4 Reasonableness of Environmental Cost

The key concept for reasonableness of environmental costs (both preventive and remedial) is that the methods employed and the magnitude of the costs incurred must be consistent with the actions expected of a prudent businessperson performing non-government contracts in a competitive marketplace. A contractor for the Government should take measures to prevent or reduce contamination just as any prudent businessperson would do to reduce its environmental costs.

Determining the reasonableness of clean-up costs also requires an examination of the circumstances of the contaminating events. Contractors should not be reimbursed for increased costs incurred in the clean-up of contamination that a prudent person would have avoided. In order for the costs to be allowable, contamination must have occurred despite reasonable attempts to avoid the contamination, and despite the contractor's compliance with the law. Increased costs due to the contractor's unreasonable delay in taking action after discovery of the contamination are not allowable. For forward pricing purposes, the costs should exclude reasonably available recoveries from insurance or other sources, which would offset the clean-up costs per FAR 31.201-5.

Audit Considerations:

The auditor must consider the underlying facts when determining whether claimed environmental costs are allowable. Items to consider include:

- Contractor records, DoD information, and local, state and federal agency records. The auditor can access the Information through the contractor, the ACO, PCOs, websites, etc.
- Documents could include those that detail how the contamination occurred. For example:
 - a chronological history of owners and operators of the land;
 - history of products produced and chemicals used at the site;
 - contractor-generated geological and environmental engineering studies;
 - internal correspondence;
 - notes or reports addressing the discovery and any clean-up of the contamination;
 - correspondence with any regulatory authority,
 - violation notices;
 - purchase and sale agreements entered into since the pollution occurred;
 - insurance policies;
 - litigation records; and
 - internal waste handling practices/policies.

26-5 Allocability of Environmental Cost

Costs incurred to prevent environmental contamination will generally be allocated as an indirect expense using a causal or beneficial base. The selection of the allocation base may warrant close scrutiny to ensure it complies with FAR and CAS. Costs to clean up environmental contamination caused in prior years will generally be period costs allocated through a company's G&A expense pool (see 26-7). However, a more specific allocation base should be used if a causal or beneficial relationship exists. Clean-up costs incurred at a home office, group-office, or other corporate-office level may be allocated to the segment(s) associated with the contamination for inclusion in an appropriate indirect pool or as part of the segment's G&A pool, if a more specific allocation base cannot be determined. Clean-up costs incurred by a segment should be allocated through an appropriate indirect pool at the segment, if no other segments were associated with the contamination. If other segments participated in the contamination, a fair share of the clean-up costs should be allocated to the other segments for inclusion in appropriate pools at those segments.

26-6 Environmental Cost Related to Previous Sites and Closed Segments

If costs arise from a site the contractor segment previously occupied, the costs for clean-up would usually be allocated to the segment's site where the work was transferred. However, if the segment is closed with none of its former work remaining within the company, the cost would generally not be directly allocable to other segments of the business. In other words, the costs could be [orphaned](#). There are many possible variations for the cost accounting treatment of environmental costs for a closed segment, depending on the facts of the particular situation. Auditors should consider the following information:

- Are any aspects of the closed segment's business being continued by the remaining segments?
- Is the site still owned by the contractor? If it is, what is its current use?
- If the site is not currently owned by the contractor, what were the terms of the sale in relation to environmental costs? The contractor may have retained environmental clean-up liability in exchange for a higher sale price or the buyer may have accepted full liability in exchange for a lower purchase price.

Each closed segment case must be reviewed based on its unique facts to determine if the costs incurred for the closed segment should be directly allocated to other segments, be allocated as residual home office costs, or be treated as an adjustment to the price of the transferred assets associated with the closing of the segment. Auditors should examine the allocation of these costs to ensure compliance with CAS 403, Allocation of Home Office Expenses to Segments.

26-7 Capitalization of Environmental Cost

[Accounting Standards Codification \(ASC\) 410-30-25](#) provides information on remediation liabilities and obligations. In general, the codification requires an entity to recognize a liability for obligations associated with environmental contamination treatment costs. Environmental contamination treatment costs are typically charged to expense. However, some environmental contamination treatment costs may be capitalized, but only if any of the following criteria are met:

- The cost extends the life, increases the capacity, or improves the safety or efficiency of property owned by the entity. For the purposes of this criterion, the condition of that property after the cost is incurred must be improved as compared with the condition of that property when originally constructed or acquired, if later.
- The cost results in mitigation or prevention of environmental contamination that has yet to occur and that otherwise may result from future operations or activities. In addition, the cost results in improvement to the property compared with its condition when constructed or acquired, if later.
- The cost is incurred in preparing a property currently held for sale.

Current period costs which increase the value of contractor assets should be capitalized for Government contract costing purposes. Capital assets purchased or constructed to prevent future contamination must be capitalized consistent with CAS 404, Capitalization of Tangible Assets, and GAAP.

Audit Considerations:

Examples of capitalization of environmental costs:

- A contractor acquires property, which was contaminated by a previous owner. Clean-up costs are capitalized as an improvement. Costs of ground and water clean-ups are increases to the book value of the land.
- A contractor cleans up contamination from its own operations since acquiring the property. If the property is being held for continuing use, the costs are expensed as period costs assuming the types of improvements listed above are not met.
- A contractor incurs \$80 million to clean up contamination it caused at a site which has a book value of \$100 million and is being held for sale at a price of \$500 million. If the sales price exceeds the cost of clean-up plus the book value, the \$80 million is realizable from the sale and therefore, should be capitalized. If the sales price were \$100 million instead, none of the \$80 million would be realizable and it should be expensed in the period.
- For this example, the clean-up in the third bullet is instead related to contamination existing at acquisition. Because the contamination existed at acquisition, the \$80 million would be capitalized even for the sale at \$100 million. The transaction would produce an \$80 million loss on the sale. In effect, this would recognize that the contractor overpaid for the land at the time of acquisition.

26-8 Potentially Responsible Party (PRP) for Environmental Clean-Up

The [Comprehensive Environmental Response Compensation and Liability Act](#) (CERCLA), as well as other laws, require a company (Potentially Responsible Party (PRP) that is potentially responsible for the contamination at a site to be individually liable for the complete clean-up of the site. The allowable environmental cost should only include the contractor's share of the clean-up costs based on the actual percentage of the contamination attributable to the contractor.

Under CERCLA, a PRP is:

- the owner and operator of a vessel or a facility;
- any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of;

- generators and parties that arranged for the disposal or transport of the hazardous substances, and
- transporters of hazardous waste that selected the site where the hazardous substances were brought.”

Audit Considerations:

The wording used above to define a PRP comes directly from the CERCLA law (42 USC 9607). The EPA website provides the following definition of a PRP:

“Any individual or company--including owners, operators, transporters or generators--potentially responsible for, or contributing to a spill or other contamination at a Superfund site. Whenever possible, through administrative and legal actions, EPA requires PRPs to clean up hazardous sites they have contaminated.”

26-9 Environmental Bad Debts of Other PRPs

Contractors with the ability to pay will be required to fund clean-up efforts for sites where they are named as PRPs. When a contractor pays for more than its share of the site clean-up, the contractor receives a right of contribution (or subrogation) against the other PRPs who did not make an appropriate contribution to the clean-up effort. If a contractor pays out more than its share of clean-up costs, it is up to that contractor to exercise its contribution rights to collect the amount over its share from the other PRPs who did not pay their share.

If a contractor cannot collect contribution or subrogation claims from other PRPs, the uncollected amounts are similar or related to bad debts and are also considered unreasonable costs. Bad debts and associated collection costs, including legal fees, are unallowable costs (FAR 31.204(d) and 31.205-3).

However, the guidance in the above two paragraphs does not apply in situations when all of the following three conditions are met:

- a contractor is legally required to pay another PRP's share of the clean-up costs;
- that PRP is out of business; and
- there is no successor company having assumed that PRP's liabilities.

When these three conditions are met, the clean-up costs, which are attributable to the other PRP's contamination, should not be disallowed as costs that are similar or related to bad debt type expenses since there is no one against whom the contractor can take recovery action. The contractor is jointly and severally liable for these costs.

26-10 Insurance Recovery for Environmental Cost

The insurance industry does not currently consider environmental contamination to be an insurable risk (at a reasonable cost) in most circumstances. The major exception is a sudden accidental contamination, such as an oil tanker spill resulting from a collision. If such insurance is available and reasonably priced, its cost would be allowable.

Some courts have found that policies written before the insurance industry began to specifically exclude environmental coverage do provide coverage for environmental damages. Any insurance recoveries for a contamination clean-up will be applied as credits against any costs which were or would otherwise be allowable for that clean-up effort.

Many environmental contamination events now generating clean-up costs were insured, either under specific environmental impairment or comprehensive general liability coverages, before the insurance industry developed its current underwriting exclusions. Most insurance companies are contesting the claims and when payments are made, they are based on partial settlements or are made after lengthy legal battles. When a claim is possible and economically feasible, the contractor should pursue it.

The auditor should inquire about the existence of environmental contamination policies and comprehensive general liability policies to determine if they contain environmental clean-up cost exclusions. The kind and amount of policies in effect from the time of the contamination to the current date are significant for the purposes of negotiating costs and prices for Government contracts.

Audit Considerations:

If there is an insurance policy, which appears to cover the time period of the contamination, the auditor should discuss with their supervisor and manager and then consider coordinating with DCAA Headquarters Policy and Legal to seek guidance concerning the policy's application to the environmental cost being claimed.

The contractor's support for proposed clean-up costs should include a description of any insurance claim the contractor may have which could reduce the ultimate liability. The amount and timing of these claims is a potential subject for negotiation, which should be addressed by the auditor and ACO (see 26-15.).

26-11 Fault-Based Liabilities to Third Parties

Fault-based liabilities occur when a third party proves the contractor's conduct was either negligent or intentional and caused the third party to suffer a loss or harm. Examples of liabilities to third parties include health impairment, property damage, or property devaluation for residents or property owners near a contaminated site. These third-party claims arise from legal theories of tort (a legal wrong) and trespass (infringing upon a property owner's legal right). Losses from such claims may be

unreasonable for payment on a Government contract under FAR 31.201-3(b)(3). Such costs are not environmental costs.

In the absence of a specific court finding of tort or trespass by the contractor, the facts of each case should be carefully examined to determine if any contractor payments are based on those or other fault-based legal theories. Before questioning fault-based liabilities to third parties, coordination should take place with Headquarters Legal to obtain an understanding of the tort or trespass court findings.

26-12 Environmental Wrongdoing

If environmental clean-up costs are the result of contractor violation of laws, regulations, orders or permits, breach of contract, or disregard of warnings for potential contamination, the clean-up costs, including any associated costs, such as legal costs, may be unreasonable per FAR 31.201-3(b)(2) and therefore unallowable.

Fines or penalties are expressly unallowable under FAR 31.205-15 and any costs of legal proceedings where a fine or penalty could be imposed are covered by FAR 31.205-47. However, the incurrence of clean-up costs to correct environmental contamination is not a penalty. Clean-up costs may be required under CERCLA or other environmental laws. Actual costs of remediation normally would not be considered fines or penalties. An award of costs under CERCLA or similar laws may combine fines or penalties with the clean-up costs. Special issues arise when a regulatory agency imposes a fine, but suspends it on the condition that the PRP perform certain actions. In these cases, coordination should take place with Headquarters Legal.

Most environmental laws do not require the contractor to be guilty of a violation to enforce contractor payment for clean-up costs. Therefore, it is rare for Government agencies to bring criminal charges for contamination. Auditors should request the contractor to provide documentation sufficient to allow a determination as to how the contamination occurred. The Environmental Protection Agency and other government agencies, in designating a company as a Potentially Responsible Party (PRP), will normally provide a written rationale as to how the company contributed to the contamination at a site.

For purposes of disallowing the costs, FAR 31.201-3(a) provides that “No presumption of reasonableness shall be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer’s representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable.”

The contractor should not be denied recovery of clean-up costs, if it complied with the laws, regulations, and permits in effect at the time of the contamination.

Audit Considerations:

Contractor wrongdoing can include, but is not limited to, failure to exercise reasonable care to avoid the contamination or failure to comply with the law. Environmental wrongdoing can occur without a formal citation or ruling by a Government agency. Working with the Contracting Officer and the environmental counsel of the affected DoD service should be considered when reviewing environmental data. Coordinate with DCAA Headquarters Policy and Legal to obtain assistance from the military services' environmental counsel to analyze the historical cost for evidence of environmental wrongdoing. When environmental cost may be questioned because of wrongdoing, a review of FAR 31.205-47 and FAR 31.205-33 may be warranted.

26-13 Nature of Environmental Cost

At the time environmental costs are being incurred, it may not be possible to reasonably estimate what the net costs will ultimately be. Even where it is settled that a contractor will be required to clean up a prior contamination, it is rare that projections of the costs necessary to complete the project can be made with a reasonable degree of certainty.

Because of the uncertainty of the cost projections and of future recoveries from the insurance companies, as well as the difficulty in identifying all the PRPs, both forecasted and incurred environmental clean-up costs and related legal costs that are allowable should be accepted with the expectation that the Government will participate in any insurance recoveries or will receive appropriate consideration if other PRPs are identified at a later date..

26-14 Advance Agreements for Environmental Cost

There are many areas of judgment involved in the determination of allowability for forecasted environmental costs. It is necessary for the auditor and the ACO to coordinate closely during the audit. Advance agreements should be considered to facilitate negotiations with the contractor.

Acceptance of the costs may require some form of agreement to protect the Government's interest. Any agreement to accept costs for clean-ups, or for the costs of pursuing insurance recoveries, should also expressly provide for Government participation in any insurance claim recoveries and any reductions resulting from later-discovered PRPs. Consideration should also be given to requiring contractor diligence in pursuing insurance recoveries and identifying contamination attributable to other PRPs. Advance agreements should provide for recovery of expenses priced into fixed price contracts if those expenses are later significantly reduced based on subsequent identification of additional PRPs or insurance coverage after the agreement on price.

26-15 Environmental Clean-Up Trust Funds

Making payments for clean-up efforts through a trust fund is an option for the administrative and financial convenience of the PRPs named at a given site. The allowability of costs on Government contracts should be based on the contractor's allocable share of the actual clean-up obligations. Contractor payments into a fund before clean-up costs are incurred are not an expense to the contractor until actual costs have been incurred for the site clean-up work. The excess or early payments are prepaid expenses.

It is the contractor's responsibility to support its claimed costs as allowable contract costs. Before accepting the contributions made to a trust fund as contract costs, auditors should obtain and evaluate sufficient supporting data to determine the allowability and the actual payment of the claimed costs. When the claimed "trust fund" costs are significant, the contractor should be requested, as part of its cost support, to arrange for Government audit access to the accounting records of the trust fund.

Call out

Orphaned Costs – An orphan cost is a cost of a division/segment that no longer exists. Therefore, the clean-up costs must be allocated in some other manner. ([Return](#))