SFAS 5 – Service Providers

Accounting Changes For Contingent Losses: An Environmental Perspective

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There is much recent controversy over the proposed changes to Financial Accounting Standards Board (FASB) 5 (Accounting for Contingent Losses) and FASB 141-R (Business Combinations [such as M&A transactions and asset sales]) that has resulted in a battle, pitting companies that must report financial results versus their shareholders, potential investors and stakeholders. The controversy surrounds a proposed increase in disclosure requirements in the context of litigation and how transparent financial reporting may adversely impact the outcome of that litigation. Nowhere is evidence of this struggle better highlighted than in the reporting of environmental liabilities that are often variable, difficult to quantify and subject to varying interpretation. The FASB defends such changes and argues that in most cases interested parties can be informed of litigation outcome impacts in a manner that does not compromise the litigation position of the reporting company (e.g., disclosure in the aggregate). This article examines the impact of recently promulgated and new potential disclosure obligations on company reporting of environmental liabilities and measures that can be taken to not only accurately quantify but minimize these risks and avoid loss of share value.

Not A New Issue

The current pending changes to FASB 5 and FASB 141-R have not occurred overnight. Rather, there has been a comprehensive "movement" in the marketplace to create consistent, accurate and transparent financial reporting in order to protect interested parties from suffering the catastrophic losses realized from several public company failures occurring over the last several years. The impacts from these failures have cost stakeholders hundreds of billions of dollars in total shareholder value loss. Additionally, with respect to many of these now defunct companies, taxpayers have been forced to bear billions of dollars more for the environmental cleanup legacies left behind by these responsible parties.

What's Happening: The Impacts & Challenges

Several market forces are developing that will reward companies that manage their environmental cleanup obligations well and conversely, penalize those that are nonresponsive. The following changes in the marketplace are creating an affirmative duty for companies to identify, assess, measure and report their environmental cleanup obligations in a manner that is transparent and consistent within their industry. These disclosure obligations must be considered by the professionals that are involved in reporting and creating solutions for environmental cleanup obligations including those responsible for the legal, audit, executive, financial/accounting, environmental and real estate functions.

• Sarbanes-Oxley holds the corporate executive, legal and auditing communities responsible through both criminal and civil statutes to create, implement and oversee systems that result in transparent financial reporting accurately reflecting the condition of the reporting company.

• Changes to GAAP such as FASB 141-R, FASB 157 (Fair Value Methodology), FASB 143/FIN 47 (Accounting for Asset Retirement Obligations), have or are in the process of replacing the historical reporting standards under FASB 5, AICPA SOP 96-1, FIN 14, and others that have in some cases led companies not to report cleanup obligations and to underaccrue for cleanup obligations that were reported.

• Increased awareness and involvement of investment groups, non-government organizations and environmental advocacy groups serving as "watchdogs" to ensure companies are accurately and transparently reporting their liabilities.

• Increased scrutiny and investigation from government organizations such as the Securities and Exchange Commission.

• Recent discussions of moving from FASB to International Accounting Standard Board (IASB) Standards will not change the discussion in this article as IASB has recently adopted a standard similar to FASB 141-R and appears to be moving in the same direction as FASB on this topic.

Of particular interest is FASB 141-R (Accounting Rules for Mergers and Acquisitions) that is already promulgated and becomes effective as part of GAAP for contingent (e.g., environmental) liabilities on November 15, 2008. This standard replaces the "probable and reasonably estimable" criteria under FAS 5 with more stringent standards that require fair value recognition of all contingencies that "more likely than not" give rise to a liability as of the date of the business combination transaction. In simplest terms, this change in GAAP is likely to result in more recognized liabilities and higher estimates/values than ever before. The following recognition and valuation criteria under FASB 141-R as contrasted to FASB 5/AICPA SOP 96-1 follow below:

- **Recognition Criteria**

  FASB 5/AICPA SOP 96-1 (Fewer Cleanup Obligations Reported): Cleanup obligations that arise outside a business combination are not recognized unless there is a *high likelihood* of a future outflow of resources.

  Compared To:

  FASB 141-R (More Cleanup Obligations Reported): All contractual and non-contractual cleanup obligations must be recognized at the acquisition date when *it is more likely than not* to give rise to a liability.

- **Valuation Criteria**

  FASB 5/AICPA SOP 96-1 (Lower Cleanup Values Reported): Cleanup obligations were typically valued at "best estimate" – the one amount within a range that is better than any other (See "most likely value" in ASTM 2137). However, when no amount within range is better than any other, FIN 14 allows the use of a minimum amount, thus creating a "loophole" for companies to underaccrue. Cutting the other direction (towards larger accruals), time value of money discounting is not allowed unless timing and amount of payment are "fixed and determinable."

  Compared To:

  FASB 141-R (Higher Cleanup Values Reported): Cleanup obligations are to be reported at "market-based" fair value. FASB 157 provides details on the fair value methodology. In general, the most reliable estimate of fair value is measured by the value that a third party would place on the assumption of the cleanup obligation in an arms-length transaction. The lowest acceptable level of fair value measurement is that derived from an expected value analysis (probabilistic methodology using decision tree analysis and Monte Carlo Simulation) that considers better and worst cases in addition to the most likely case to establish a more realistic value for the cleanup obligation and in essence assigns a probability-weighted value based on a range of values. This valuation methodology considers all "life-cycle" costs to mitigate a cleanup obligation such as: overhead, vendor profit and market risk premium.

The most recent proposed changes to FASB 5 and FASB 141-R are disclosure related and do not impact the balance sheet. These changes would require the disclosure of all but the most remote environmental litigation and clean-up obligations as well as a discussion of the potential costs for such costs in the accounting notes. The potential impact associated with a broad disclosure requirement of this type could be problematic if not handled carefully.

Again, these requirements should be able to be met without compromising the reporting company's position with counterparties related to the contingent losses.

In addition to the likely increase in the number of obligations being reported at higher value, several other challenges and impacts are to be expected, which are highlighted in the context of a business combination transaction:

• *Buyer and Seller Due Diligence*: The recognition and valuation requirements of FASB 141-R are going to result in new and more extensive due diligence requirements, development of new valuation models and practices, training of due diligence teams and valuation experts.

• *Impact on Deal Timing:* Obviously more time will need to be spent in due diligence on establishing the value of cleanup obligations.

• *Potential Failed Transactions*: The rise in the number and increase in value of cleanup obligations reported may jeopardize many transactions.

• *New Accounting/Legal/Technical Judgments*: A multi-disciplinary approach will be essential to the evaluation of cleanup obligations.

• *Legal Issues*:
  – Response to audit letters
  – Increased tension between corporate/litigation bar

• *New Negotiating Tactics and Strategies*: How cleanup obligations are managed in a transaction will become more complex and likely involve the development of a sophisticated risk management plan, valuation analyses and risk allocation provisions.

• *Risk of Disclosure*: The disclosure of cleanup obligations could jeopardize the regulatory outcome of the selected remedy if too much information is disclosed. Regulators and other stakeholders could use disclosures against a reporting company in dealings regarding the remedy to reach regulatory closure and the posting of requisite financial assurance. Care should be taken to accurately disclose but protect the reporting company's interest in their dealings (e.g., as FASB has suggested perhaps an aggregate disclosure).

The Good News

Overall, in the long term, the balance of impacts appears to be positive and should result in increased shareholder value via:

• **Reduced Impact to Future Earnings and Cash Flows**: Not understanding a cleanup obligation can often result in surprise expenditures that disrupt earnings and cash flows, resulting in significant impacts to shareholders. The changes mentioned in this article should lead to a full life-cycle understanding of the cleanup obligation in its entirety (identification and quantification) that will facilitate effective mitigation planning and management. Once the fair value of a cleanup obligation is realized, companies may consider transferring these liabilities to third party companies that specialize in the perpetual fixed-price assumption and mitigation of the cleanup obligations, thus relieving this concern.

• **Avoidance of Audit Failures and SEC Enforcement Actions:** The impact of an audit failure for not properly accounting for cleanup obligations would likely carry a heavy market-driven penalty (decrease in share price) far in excess of any benefit of not previously reporting the obligation.

• **Better Performance Metrics and Reduced Investment Risk**: The quantification and disclosure of environmental obligations no longer needs to be addressed through a "black-box," wide-sweeping disclosure caveat. The investment community is beginning to look closely at a company's position on sustainability and other "green-related" matters as a reflection of its core values, efficacy of management and stature in the market place. Analysts may grow suspect of a company that does not show measurable success in mitigating and properly calculating its cleanup obligations. Lack of such sophistication may increase a risk premium associated with a company's value that far exceeds the cleanup obligations themselves.

• **Increase of Liability/Asset Liquidity**: Companies may be underaccrued for their cleanup obligations. Although compliance with these standards may bring short term pain, the fair value accounting of these cleanup obligations will make such liability and its underlying asset more liquid as there should be no stigma associated with the asset. Once valued at fair value, the impact of transferring the liability via a fixed-price arrangement with a third party company specializing in the costing and management of environmental cleanup risk and such should become easier.

• **Realization of Latent Asset Value and Sustainability Initiatives**: In the past, companies may have preferred to mothball an asset that had the potential for environmental contamination. In many cases the underlying asset value (real estate, natural resource value: wetlands, water rights or NRD settlement) may more than offset or at least mitigate the cleanup obligation. From a sustainability standpoint, these properties are often located in urban areas that may well end up being redeveloped for industrial, commercial, residential and green space purposes thus creating value to society "at large." Companies may find public stakeholders willing to participate in funding such developments through grants and tax abatement programs.

• **Premium Pricing for Assets:** A company demonstrating a strong understanding of cleanup obligations will not experience a valuation discount or the stigma associated with undervalued liabilities and therefore should maximize the valuation of its assets.

• **Other Benefits for Transferring Cleanup Obligations:** Transferring cleanup obligations to a third party company at a fixed-price can create additional benefits such as: cost and cash flow certainty, elimination of inter-party dependence, accelerated tax deduction, removal from balance sheet and reduced overhead costs.

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