Fair Value Accounting: 141(R) and Environmental Liabilities

This month's "Community Commentary" submission looks at how dealmakers should approach environmental liabilities as they prepare for fair value accounting measures to take effect

By Jon Walker and Elizabeth Krol

A newly revised accounting standard that aims to increase the transparency of mergers and acquisitions transactions may up their complexity factor, at least in the short term, as companies struggle to develop procedures for estimating fair value.

Issued December 4, 2007 as part of the Financial Accounting Standards Board's plan to align U.S. accounting practices with international financial reporting standards, FAS 141(R) requires U.S.-based companies to, among other things, measure certain contingent liabilities assumed in an M&A transaction, such as environmental cleanup, at fair value. The new requirements, which take effect for fiscal years beginning after December 15, 2008, represent a significant departure from the current practice of recording liabilities only once they become probable and reasonably estimable.

Fair value, which is defined in a recent statement known as FAS 157, will improve the relevance, representational faithfulness and comparability of information reported in business combinations, but may place a substantial burden on M&A teams, who must develop complex methods for determining the fair value of contingent liabilities before the January deadline.

A failure to develop a supportable process to assess the fair value of contingent liabilities can pose obstacles to M&A transactions in two significant ways. First, it can lead to volatility in earnings after the transaction closes. Second, it can force a company to revise prior period earnings. Thus, companies planning to take part on either side of an M&A transaction should begin preparing for FAS 141(R) now. They can do so with respect to environmental liabilities-which can play a significant role in business combinations-by asking the environmental professionals they work with to step up environmental due diligence. The more information valuation professionals have to work with, the more reliable their calculations will be.

Contingent Liabilities and Valuation

Contingent liabilities are unknown obligations whose payout is based on the outcome of a future event, such as a lawsuit or environmental cleanup. Understandably, determining fair value based on assumptions is no easy task. "Historically, the determination of fair value for contingent liabilities was typically not done, so an accepted process within the valuation community for establishing the fair value of contingent liabilities doesn't exist," says John Formica, a partner with PricewaterhouseCooper's National Professional Services Group. "Just like it did for intangible and fixed assets, the practice will evolve over time."

The wiggle room that results from fair value accounting could prove to be problematic for companies involved in mergers and acquisitions, says Greg Rogers, president of Advanced Environmental Dimensions, a consulting firm. "If buyers fail to get the fair value estimates right initially, they will have to revise prior period financial statements rather than make an adjustment in the current period." He adds that some experts fear that the high degree of subjectivity involved in fair value measurement of contingencies may encourage manipulation.

How Environmental Liabilities Factor In

While they're certainly not the only contingent liabilities subject to FAS 141(R), and in many cases they're not material, environmental liabilities can play a significant role in M&A deals, especially in certain industries-chemical companies and paper mills come to mind. Sometimes environmental contingencies are a determining factor in a deal.

Although it is unlikely that environmental professionals will have direct experience applying FAS 157, which provides specific methods for measuring fair value, they will play a key supporting role in the process of accounting for environmental liabilities. At a minimum, they will collect much of the environmental data necessary to develop the cost estimates, and in some cases may be called upon to help develop fair value estimates. To that end, companies should make sure the environmental professionals they hire have a basic understanding of fair value.

"This rule change places enormous pressure on M&A deal teams, including environmental professionals, to develop supportable and auditable fair value estimates in a short period of time," says Rogers. "While environmental professionals will likely be unfamiliar with FAS 141(R), this

FAIR VALUE continued on page 76

ACG

DEAL TALE continued from page 73

situation. A medium-sized or "boutique bank" may make a lot of sense. It's also important to consider the experience of the loan officer(s) and accessibility to senior management.

A third lesson is to determine who's in charge. The account officer should be senior enough to have a loan limit approval authority and portray the necessary confidence to seemingly make decisions without the loan approval process being paralyzed through endless committee meetings.

Finally, seek a banker who exudes open-mindedness and is not risk adverse in this turbulent credit crunch cycle, and can work through unanticipated head winds. Just prior to closing this real estate refinancing, the title company discovered the borrower's deceased husband (and former owner) had been involved with a 50% partner years ago, and for some inexplicable reason, the owner's prior attorney had not properly completed the partnership discharge lien on the property (even though the existing lender had not been concerned).

Also, the trust document had not been properly witnessed passing on the beneficial interest to the spouse vs. the two children. Compounding the difficult closing situation was the Probate Judge assigned to resolve the current situation, was leaving on a three-week vacation, and the matter having to be postponed at the last minute pending the Judge's return. That necessitated last minute legal changes to the closing documents and extending the Forbearance Agreement with the existing lender. A lesser experienced lender may not have prevailed in having to navigate through these challenges.

There is an upshot to leap-frogging the learning curve: Lending is unequivocally a subjective process, but seeking out a knowledgeable banker, and a bank (without loan baggage from the credit crunch) willing to pursue a creative and innovative approach, requires investing time and credibility to make the difference.

Lawrence Gardner is the President of Lawrence Gardner Associates

FAIR VALUE continued from page 74

is simply due to the fact that the new requirements are not yet effective; their clients have not called on them to help implement the new standard. But the environmental firms that offer liability buy-outs are skilled at developing market-based estimates, and should be well prepared to deliver FAS 157 fair value amounts for contingent liabilities."

To help account for environmental liabilities, M&A professionals can also access publicly available environmental information about companies and properties online; a handful of companies that specialize in compiling environmental data from federal, state and local vendors offer this service.

FAS 157 became effective with respect to non-financial assets and liabilities for financial statements issued for fiscal years beginning after November 15, 2008.

Preparation is Key

Under the new accounting requirements, all deals will be under greater scrutiny, which means more pressure on the due diligence that a company does. "The key to effective fair value measurement comes down to getting as much information as you can," says Formica. Sellers should prepare their records prior to putting property and companies on the market. Buyers should request detailed documentation and allow enough time to ensure they understand potential liabilities and known risks associated with the property or company to be acquired.

With respect to environmental liabilities, sellers should estimate the fair value of those liabilities on a pro forma basis before going to market. They might also consider exploring options to remediate contaminated properties or transfer severable environmental liabilities to a third party prior to or in connection with the sale of the company. Buyers need to ramp up due diligence procedures, develop the capacity to produce supportable fair value estimates in the course of a transaction, and revise their accounting policies and procedures to differentiate between existing reserves, newly acquired contingencies and asset retirement obligations.

Meeting the new requirements of FAS 141(R) could pose an obstacle to mergers and acquisitions when the buyer and seller are unprepared. Those who take advantage of the time left by preparing now will be in a good position when the standard takes effect next year. Fair value estimates will increase deal transparency, but only if the valuations are good.

Jon Walker is a managing director at Environmental Data Resources, while Elizabeth Krol is the Northeast due diligence program manager at Shaw Environmental.

THE PULSE continued from page 75

that debt as purchase price consideration for the assets to be acquired. To achieve attractive returns, buyers should target businesses with positive cash flow as well as those sectors that are highly leveraged, such as utilities, healthcare and telecom. Buyers should be mindful of their priorities to avoid potential disruption of their existing business from integrating newly purchased assets, regardless of purchase costs.

Michael Quinn
Partner
and
David Solomon Jr.
Intern
Q Advisors LLC

Be the next member to be featured in the Pulse. Each month, we'll pick a hot topic concerning M&A, growth strategies and general market commentary, with several ACG members offering a brief, candid viewpoint of no more than 200 words each.