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Airing Out ''Mothballed'' Facilities

A proposed accounting standard might have companies looking twice at factories and other buildings that have been temporarily shuttered.

Marie Leone, CFO.com
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In August, the Financial Accounting Standards Board proposed a new interpretation of FAS No. 143, Accounting for Asset Retirement Obligations (AROs). Scheduled to be finalized by the end of this year, the proposal would effectively require many companies to book their AROs more quickly than in the past.

The proposal has garnered few corporate fans; most critics have argued that the scope of the new interpretation is too broad to be practical. As of early October, FASB had received 20 letters from corporate accountants as well as a handful from CPA societies and trade groups, all of which maintain that the proposal needs work.

Seemingly unnoticed by the critics, however, is a loophole regarding idled, or "mothballed," facilities that would itself be shut down, permanently. Mothballing — temporarily shuttering a factory or building until business conditions warrant reopening it — is a common practice, used mostly in the industrial sector. Just this month, technology company Corning Inc. and energy company Texas Genco Holdings put facilities into mothballs, noted the shutdowns in their financial statements, and described the business conditions that would warrant a restart. Neither company was required to book an ARO.

Indeed, the current interpretation of FAS 143 does not specify whether such obligations should be booked immediately or upon retirement. By allowing companies to delay recognizing the ARO, FAS 143 has also enabled them to delay triggering environmental cleanup laws, defer cleanup costs, and keep liabilities off their balance sheets. (See "We're Booking as Best as We Can," at the end of this article.)

There's no evidence that either Corning or Texas Genco Holdings intends to avoid any legally mandated environmental cleanups that might eventually be required. However, if the proposed interpretation of FAS 143 is approved in its current form, many companies will be forced to rethink their asset management strategy to comply with generally accepted accounting principles as well as the rigorous fair-disclosure regulations mandated by the Sarbanes-Oxley Act.

Don't Ask, Don't Tell

The loophole has been considered an open secret at the Environmental Protection Agency and among environmental lawyers, consultants, and socially responsible investors (SRIs). The corporate managers who actually use it, on the other hand, don't discuss their strategies, according to several industry sources who asked not to be identified.

By following the "don't ask, don't tell" policy implicit in the current FAS 143 and not including reports on mothballed facilities in their financial statements, those managers can make it much more difficult for the EPA, the Securities and Exchange Commission, and other agencies to track violations. If those managers were to discuss the loophole openly, they might trigger environmental cleanup laws sooner rather than later.

Because information about this type of mothballing is so difficult to gather, SRIs and other advocates for the proposal say they won't be able to accurately measure its effects — or even determine how many businesses have taken advantage of the existing rule's ambiguity. Collectively, however, they hope the new interpretation will cajole more companies to come clean about their environmental burdens.

Good, and Good for You

They also suggest that if all businesses were required to own up to those liabilities, those companies that addressed them more quickly and more completely would have an advantage in public perception, if not in the capital markets.

Companies certainly aren't helping themselves when they defer reporting liabilities associated with mothballed facilities, says Tim Little, executive director of The Rose Foundation for Communities and the Environment, a research and advocacy organization. In his report "Fooling Investors and Fooling Themselves," Little writes, "Over time, these mothballed sites become 'brownfields' whose often unquantified toxicity is a major obstacle to economically productive reuse."

A brownfield is real property that requires environmental remediation but is still marketable, explains Joe Dufficy, brownfield program director for the EPA's Chicago office. He reckons that between 400,000 and 600,000 brownfield sites have been identified in the United States — but he adds that it's virtually impossible to determine how many are mothballed facilities because so little information exists in public records. Owners of these stealth sites should come clean about environmental liabilities, believes Dufficy, if only because a potential property buyer would deeply discount a property with a cost that can't be measured.

A stronger reason for coming clean that finance executives already know very well, says Robert Lipscomb, is that just because a facility is in mothballs doesn't eliminate all the carrying costs. Lipscomb, the brownfield program manager for architectural and engineering firm Barge Waggoner Sumner and Cannon Inc., notes that ongoing expenses include taxes, insurance, security, maintenance, and the cost of management's time.

Total annual costs can easily top $100,000, according to Lipscomb; on a present-value basis, an average mothballed site would be carried as a $2 million liability. For a dormant asset, he reflects, that's a significant burden on the balance sheet, especially since it's greater than the cost of environmental liabilities for most brownfields. What's more, this doesn't take into account the lost opportunity of reinvesting the proceeds from the sale of a clean property. Observes Lipscomb, "Current accounting practices can obscure the value of the clean asset as well as the value of the liability."

Another approach is to transfer the cleanup — and the risk — to another party. To a sell a riverfront site that was home to 150-year-old power plant, Consolidated Edison of New York paid the TRC Cos. a fixed fee (reportedly, $103 million) to decommission the site, removing asbestos and lead paint, demolish the plant, and return the site to a condition approved for mixed-use development. After receiving the OK this month from New York's public-service commission, Con Ed is ready to seal a real-estate deal with East River Realty. The property will fetch between $300 million and $600 million, depending on its final use.

And What about Those Audits?

Greg Rogers believes that public-company directors and officers may also be caught off-guard by the new FAS 143 interpretation. Rogers, a practicing environmental lawyer and non-practicing CPA with Guida, Slavich and Fores, notes that many corporate accountants have defer booking environmental liabilities, based on their interpretation of the current FAS standard and existing environmental laws.

However, Sarbanes-Oxley Section 404 (which requires an independent audit of a company's internal financial controls) and the new FAS interpretation may, in combination, require companies to inventory their mothballed sites and book the related environmental-cleanup obligations. Failure to do so might be viewed as a control deficiency under Section 404, possibly requiring the company to disclose a material weakness for environmental financial reporting. Such a disclosure could expose the company to bad press, an SEC investigation, and shareholder lawsuits against the company and the board.

Those directors and officers may be surprised to learn that their D&O insurance policy contains a "pollution exclusion" as well as other provisions that could deny coverage. In February, a decision by the U.S. Fifth Circuit Court of Appeals involving a shareholder lawsuit against U.S. Liquids Inc. upheld the validity of such a pollution exclusion. That suit — in which shareholders alleged that the company did not fully disclose environmental matters in SEC filings — "should be sounding alarm bells for directors and officers of public corporations with significant environmental exposures," warns Rogers.

Historically, the commission itself has not pursued enforcement actions against companies for underreporting their environmental liabilities — but the Section 404 requirements of Sarbanes-Oxley add a new twist. Accordingly, urges Rogers, companies with mothballed facilities should talk with their independent auditors now to avoid unpleasant surprises in 2005.

Marie Leone is senior editor of CFO.com.

We're Booking as Best as We Can

In the two years since the effective date of FAS No. 143, Accounting for Asset Retirement Obligations, the staff of the Financial Accounting Standards Board have noticed that corporate accountants are not consistent in booking the effects of these legal obligations, especially when they are conditional on future events.

Asbestos-removal laws, for example, constitute a legal obligation triggered when a company renovates or demolishes a building containing the flame retardant. In such a case, says BDO Seidman partner Ben Neuhausen, some accountants have deferred recognizing an ARO when retirement of the building was not yet planned, on the grounds that the legal obligation to remove the asbestos did not yet exist.

Neuhausen explains that since the future conditional event — such as retirement, renovation, demolition, sale, or refinancing of the building — is usually controlled by the asset owner, one might maintain that in those cases, it would be the asset owner who would pull the trigger, so to speak. In other words, unless a company were required by law or court order to initiate one of those events, booking the ARO could be deferred.

Other accountants in similar situations, figuring that the asset would someday be retired, recorded the fair value of the liability immediately. Of course, booking the ARO triggered environmental cleanup laws immediately, too.

The accounting board's proposed interpretation of FAS 143 would eliminate these different accounting treatments by directing companies to book the fair value of an ARO immediately, regardless of whether the legal obligation is conditional on a future event. "It's FASB's assumption that every asset has a finite life," maintains Neuhausen.

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