On the Cutting Edge: An Insider's Perspective

More Environmental Accounting Changes on the Horizon for 2008

Continuing its move toward harmonization of U.S. accounting principles with European standards, the Federal Accounting Standards Board in December 2007 released a revised standard that will change the way contingent liabilities, including environmental liabilities, must be recognized for acquisitions, a Chicago-area lawyer told BNA Jan. 8.

The FASB standard on *Business Combinations* (FAS 141) addresses how parties must recognize and measure costs, expenses, and liabilities associated with an acquisition.

The revised standard issued in December 2007 requires fundamental changes in accounting practices for acquisitions that take effect after the fiscal year beginning Nov. 15, 2008, Laura Leonard said. Leonard is a partner with Sidley Austin LLP in Chicago.

"This means another year preparing for readjustments for anyone involved in environmental reserve-setting or diligence," she said.

'More Likely Than Not'

While the standard does not focus on environmental liabilities per se, those liabilities are impacted by the portion of the standard addressing assumed contingent liabilities, Leonard explained.

Under the revised standard, such liabilities no longer are governed by FAS 5, *Accounting for Contingencies*, if they are assumed in an acquisition. The significance here, Leonard explained, is that under the FAS 5 rules, contingent liabilities only had to be accounted for if they were "probable and reasonably estimable." Under FAS 141, those same contingencies must be recognized if it is "more likely than not" that they meet the FASB definition of an asset or liability.

"Accountants generally are interpreting 'more likely than not' to mean more than a 50 percent chance," she said.

Under FAS 141, the required method of estimating assumed contingent liabilities is "fair value," Leonard explained, the same method that caused such headaches when FASB's accounting standard for asset retirement obligations, FAS 143, was issued (14 EDDG 27, 4/21/05).

Because there are so many variables, determining fair value for contingent environmental liabilities usually means using probabilistic estimation to come up with an "expected value" as of the acquisition date. That expected value then actually must be booked.

Furthermore, Leonard explained, if you are not able to put a number there, you need to explicitly state why you cannot estimate the potential liability. The standards board would rather have people put their best guess on the books and have that number change over time as the factors that affect the numbers change.

"Although the numbers may be speculative, FASB's view seems to be that where the potential for liability is greater than 50 percent, some reasoned number is better than no number," she said.

Leonard notes that FASB's standard for calculating fair value, FAS 157, may be the subject of some clarifying pronouncements this year. FASB has proposed delaying the effective date of FAS 157 as it applies to nonfinancial assets and liabilities until fiscal years beginning after November 2008.

Due Diligence Impact

From a due diligence standpoint, Leonard said, this change in accounting standards will require careful consideration of consultant cost estimates developed for due diligence purposes. Where such estimates used to be a basis for negotiating purchase price adjustments or bolstering indemnifications, FAS 141 may trigger actual accounting ramifications. Further, because all relevant facts may not be available during pre-acquisition due diligence, those estimates may be developed based on incomplete information.

The revision reflects the growing convergence of U.S. and European accounting standards. The prevailing view now is that uncertainty does not excuse the duty to estimate potential liability. In the United States, "fair value" is becoming the norm, Leonard explained, even for contingencies.

"It used to be that 90 percent of what environmental practitioners worried about was covered under FAS 5." Slowly, the universe of liabilities evaluated under FAS 5 is being reduced, replaced by other standards that require parties to put an immediate fair value number on contingent liabilities where traditionally there would need to be a trigger, such as an enforcement action or private lawsuit.

Leonard also noted fair value is very difficult to determine for environmental liabilities. "Clearly, FASB indicates a preference to measure fair value as market value based on comparable transactions, meaning a market price," Leonard explained. When the asset or liability lacks a market price, which is the case for environmental liabilities that have not yet materialized, one needs to look at other factors.

"The accounting world isn't really sure how this is going to be done," she said. Some consultants are trying to develop a market price aspect to it, looking at environmental risk transfer transactions and environmental insurance as potential guideposts. The risk transfer market remains an immature market, she added.

Because FAS 141 is very complex and filled with technical accounting jargon, Leonard believes the new accounting requirements in the revised standard may be a "sleeper issue" for environmental practitioners. In any event, the process for making such estimations is hardly settled. She predicts that, at a minimum, there will have to be far more collaboration between the environmental due diligence and financial teams to ensure the cost numbers are dealt with properly after the acquisition is complete.