Better to be Vaguely Right or Precisely Wrong?

By C. Gregory Rogers

John Meynard Keynes, a British economist, said he would rather be vaguely right than precisely wrong. When it comes to estimating contingent liabilities in mergers and acquisitions, U.S. and international accounting standard setters now seem to agree.

In new standards for business combinations issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), the oracles of accounting have abandoned the long-standing rules for recognizing and measuring contingent liabilities. Instead of booking only the amount that is nearly certain to be spent in order to settle a contingent liability, acquiring companies will soon be required to report the market value of the obligation, uncertainties and all.

Beginning in 2009, public and private companies will be required to record contract-related contingencies assumed in a merger or business acquisition at their acquisition-date fair value. Non-contractual contingencies also must be recorded at their acquisition-date fair value, but only if legal counsel determines that is more likely than not that a liability exists as of the acquisition date.

The fair value of a liability is the price that would be paid to transfer the liability in a hypothetical transaction between market participants (exit price). A market quote in an active market is the best evidence of fair value. If an active market does not exist, companies must estimate the exit price based on the assumptions that market participants would use in pricing the liability.

To understand how fair value measurement will affect environmental liabilities in M&A deals, consider the following examples:

Example 1: Buyer plans to purchase the stock of Seller. Seller owns an industrial facility with soil and groundwater contamination resulting from historical releases of chlorinated solvents (TCE) caused by Seller. Seller estimates that a thorough site investigation will cost \$250,000. Depending on the extent of contamination, cleanup costs are expected to range between \$2 million and \$10 million. In accordance with applicable accounting standards, Seller has used the reasonably estimable cost of the investigation as a surrogate for the known minimum value of the total cleanup and booked a contingent liability in the amount of $250,000. Buyer estimates that it would charge $5 million to assume cleanup liability for the facility in a stand-alone transaction. This estimate is comparable to a quote obtained from a liability buy-out company. Upon acquisition of Seller, instead of recording a $250,000 liability, Buyer records a contingent liability in the amount of $5 million representing its estimate of the acquisition-date fair value of the cleanup liability.

Example 2: Same facts as above, except that preliminary investigation indicates that TCE in groundwater has migrated offsite under a residential neighborhood at concentrations posing a risk of vapor intrusion. As of the acquisition date, Seller has not notified the government or the adjacent property owners and no claims have been asserted against Seller. In accordance with applicable accounting standards, Seller has not recorded a contingent liability for unasserted claims for property damage or bodily injury because Seller does not consider litigation to be probable (highly likely) and it believes the amount of the potential loss cannot be reasonably estimated. Based on existing information, Buyer's legal counsel concludes it is more likely than not that Seller is liable for trespass and related property damages (but not for bodily injury). Considering possible outcomes of potential litigation, including possible out-of-court settlement, Buyer's counsel estimates the reasonable worst-case outcome for property damage claims is a loss of $15 million. Buyer obtains three quotes for 10-year environmental insurance policies with limits of $15 million that would respond in the event of lawsuits by offsite impacted property owners arising from pre-existing pollution conditions (bodily injury and cleanup cost coverage is excluded). Upon acquisition of Seller, Buyer records a contingent liability in the amount of $1.5 million — the average of the three insurance premium quotes — as its estimate of the acquisition-date fair value of Seller's offsite property damage liability.

Example 3: Same facts as above, except that Seller recently sold the facility in 2001 and gave the current owner an unlimited contractual indemnity for third-party claims for cleanup costs, property damages, or bodily injury arising from pre-existing pollution conditions. At the time of the acquisition, no third-party claims have been asserted and the current owner has made no demand against Seller under the indemnity. In accordance with applicable accounting standards, Seller has not recorded a contingent liability for its contractual indemnity obligation because Seller does not consider a claim to be probable (highly likely) and it believes the amount of the potential loss cannot be reasonably estimated. Based on available information and experience with vapor intrusion litigation in other parts of the country, Buyer's counsel estimates the reasonable worst-case outcome for bodily injury and property damage claims is a loss of $100 million. Buyer obtains a quote in the amount of $10 million for a 10-year, $100 million environmental insurance policy that would respond in the event of claims for bodily injury or property damage arising from pre-existing pollution conditions (cleanup cost coverage is excluded). Only one carrier was willing to underwrite the risk. Upon acquisition of Seller, Buyer records a contingent liability in the amount of $15 million — $5 million for cleanup (see

Example 1) plus the insurance premium quote for bodily injury and property damage coverage — as its estimate of the acquisition-date fair value of Seller's contractual indemnity obligation.

The new accounting standards will not affect acquirers' economic exposure to contingent losses. However, as illustrated by these examples, fair value measurement of environmental liabilities in mergers and acquisitions can be expected to result in more recorded liabilities and higher, sometimes much higher, estimates. In addition, the new standards require companies to provide more disclosures about acquired contingencies, including the nature and amount of the contingencies as well as the potential range of outcomes, which could prejudice a company's ability to settle pending claims or avoid litigation altogether.

Fair value measurement will affect buyers, sellers, and deal advisors in many ways. For example, prospective buyers should evaluate the impact of the new rules on deal timing and consider how fair value estimates of acquired liabilities (vaguely right) may reflect on the reasonableness of existing environmental reserves (precisely wrong). Prospective sellers should expect increased buyer sensitivity to environmental contingencies and take preemptive steps to enhance marketability and value. Deal advisors, who generally are unfamiliar with fair value measurement, face the challenge of quickly building a multi-disciplinary capability to deliver a highly complex due diligence and valuation process.

In conclusion, new accounting standards for business combinations will affect how environmental liabilities are measured and reported in M&A deals and also may impact corporate policies and procedures for existing reserves. Fair value measurement of environmental liabilities generally can be expected to result in more recorded liabilities, higher estimates, and more detailed disclosures. Generating fair value measurements for environmental liabilities will require a highly complex due diligence and valuation process. The new standards won't take effect until next year, but now is the time for buyers, sellers, and deal advisors to start getting prepared, so that it will indeed be better to be vaguely right than precisely wrong.