FIN 47: The Future Is Now

Under the new standard, many companies may have to book future cleanup costs, whether or not they can be ascertained today.

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Buried within the flurry of earnings releases issued during the past two weeks were reports by a handful of large companies of charges related to FIN 47, an accounting rule that went into effect in December. The immediate result of their applications of the new standard, which governs disclosures related to future environmental liabilities, were modest hits to net income and earnings per share.

For instance, Ford Motor Co. recorded a $251 million after-tax charge to net income for 2005 and an accompanying 11 cent reduction in earnings per share. United Technologies Corp. posted a $95 million charge, which shaved 9 cents off annual EPS. Similarly, USG Corp. and ConocoPhillips saw their annual net incomes cut by $11 million and $88 million respectively. USG's per-share earnings dropped 25 cents, and ConocoPhillips's fell by 7 cents.

The longer-term effect of FIN 47, however, will not be apparent until companies that are bound by the new rule issue their annual reports later this year. That's when investors will get a look at the effect that estimated future cleanup costs will have on balance sheets.

The standard is a new interpretation of FAS 143, Accounting for Asset Retirement Obligations, which was issued in June 2001. Under the new reading, affected companies must recognize on current financial statements future environmental liabilities associated with permanently shutting down a facility.

In the past, companies interpreted FAS 143 differently. They reckoned that the liability only had to be booked when the cleanup cost and the timing of the facility closing were relatively certain. Independent auditors agreed, but the Financial Accounting Standards Board continued to mull the practical application of the rule.

Originally, FAS 143 pertained to the future cost of cleaning up nuclear power plant sites after the facilities were shuttered. The standard instructed plant owners to estimate future liabilities (including cleanup and remediation costs) using a discounted cash flow model. After that, they should recognize the charge every year until the plant entered retirement, according to FASB.

From an accounting perspective, as the plant ages and moves closer to retirement, the amortized asset is written down while the liability grows. By the time the plant is closed, the liability turns into a cash outlay.

Further, power plant owners are obligated by law to eventually clean up the site, which means that the liability is a sure thing. It was that widespread certainty that led FASB to suggest that nuclear power plants were not the only facilities that should fall under the auspices of FAS 143.

For five years, FASB, auditors, and companies had tangled over the question of whether the owners of factories, warehouses, coal-fired power plants, and other industrial facilities should also be made to recognize future environmental liabilities. Finally, on December 15, FIN 47 was released, clarifying FASB's position: Any company required by contract or statue to perform an environmental cleanup after retiring a facility must book the future cleanup cost — whether or not it can be ascertained today.

In addition to recognizing the future environmental liability on its balance sheet, a company must also make appropriate disclosures about the cost and timing of obligations in shuttering the facility. Further, each affect companies must take a one-time "cumulative" accounting charge to net income as a way of truing up their books in light of the new rule.

The one-time charge is what popped up in the earnings releases over the last two weeks. In essence, those companies had to imagine that FIN 47 was in effect when they built or bought their facilities and then figure out what charges would have been taken in the time between when they built or bought the plant and December 2005.

No Sweat on the Street

The recently reported adjustments didn't seem to bother Wall Street. Nicole Decker of Bear Stearns, for instance, didn't mention it in her evaluation of ConocoPhillips. JSA Research's Paul Nisbet says that despite

being surprised by the United Technologies disclosure, the charge would not hurt the company's future share price in any material way.

Companies that haven't reported the charges yet, however, could face greater risks. Such companies might, for example, receive audit opinions marred by a statement of material weaknesses in their financial controls if they fail to the new address asset-retirement cleanup reporting issues. "Some companies may be asleep at the switch on minor accounting issues like FIN 47," says Jay Hanson, national director of accounting at McGladrey and Pullen LLP.

The sudden awareness of that kind of sleepiness might spook investors. Indeed, a study released last year by shareholder-advisory firm Glass, Lewis & Co. revealed that on average, the day after a company disclosed a material weakness in its financial controls, its share price dropped 0.67 percent relative to market movement. After a week, the share price dropped 0.90 percent; and after 60 days, the price tumbled 4.06 percent.

The new rule, however, just doesn't appear on many corporate radar screens. A number of auditors confirm that clients come to them with questions about the FIN 47 infrequently. Frankly, says McGladrey's Hanson, most companies are consumed by efforts to comply with the new stock-option accounting rules under FAS 123R.

For now, "independent auditors are driving this first round of FIN 47 disclosures," says Greg Rogers, president of Advanced Environmental Dimensions, a consulting firm. Audit firms routinely look to each other for rule interpretation precedents and apply them in such a way that they eventually become industrywide practices, he says

But not every company needs such prompting. Consider United Technologies. While the aerospace company's auditors approved its application of FIN 47, its internal accounting team first brought the issue to light. Internal accountants started working on FIN 47 in May, according to Jay Haberland, vice president of business controls at United Technologies.

Companies affected by FIN 47 will likely hail from the industrial sector, and include utility, refinery, mining, and chemical companies, says Doug Reynolds, a national office partner with auditor Grant Thornton. He adds that those are the companies with enough capital to build a facility large enough to affect the environment and therefore require a cleanup contract before receiving siting permits.

Nevertheless, Reynolds points out that any company with an official pact obligating it to clean up before shuttering a site could be affected, including tiny neighborhood dry cleaners or home-heating-oil companies with oil storage tanks.

Further, financially troubled companies may not fare well under FIN 47 unless they have already recognized the risk. For example, booking a significant liability could tip the balance sheet of a distressed company into bankruptcy, Rogers contends.

At the same time, companies' ability — or inability — to estimate their liabilities remains a major bone of contention. Estimating the future cost is complicated by unclear accounting rules, changing environmental laws, lack of accurate data about remediation fees, and new discoveries of polluted sites, according to companies that have filed comment letters on the subject with FASB. In other words, says McGladrey's Hanson, some companies may claim that they have no idea of how to accurately estimate their future environmental liabilities.

Under the new regime, however, those companies must disclose to shareholders that estimating future clean-up liabilities is virtually impossible for them. The upside to such a statement is that the charge, if there's any, could likely be low-balled. The downside is that admitting that future liabilities are unknown might be an open invitation to investor criticism, scrutiny into controls weaknesses, or a shareholder lawsuit.

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