Ready for Sarbanes-Oxley Certification?

It's Time To Be Prepared

By C. Gregory Rogers and Robert Lipscomb

Corporate real estate managers, are you ready to certify the accuracy and completeness of your company's financial statements? If you have not yet been asked to do so, get ready. Your CFO likely will be calling soon. And if you are thinking it is no big deal, consider that your corporate real estate department might be unwittingly responsible for harboring material off-balance sheet environmental liabilities.

Changes in accounting rules will have a dramatic impact on how pollution cleanup liabilities are identified, valued and reported. These rules will also dramatically increase the level of cost and effort to identify, assess, and estimate environmental liabilities. Compliance with these new financial reporting requirements will require processes and multidisciplinary teams that most companies do not have at hand.

Sarbanes-Oxley

The Public Company Accounting Reform and Investor Protection Act of 2002, better known as Sarbanes-Oxley, was passed in response to a series of high-profile accounting scandals including Enron and WorldCom. Under Sections 302 and 906 of Sarbanes-Oxley, CEOs and CFOs of public companies are now required to certify that their company's financial statements "fairly present" the financial condition and results of operations of the company.

CEOs and CFOs must also vouch for the effectiveness of the company's financial reporting system. Moreover, under Section 404 of Sarbanes-Oxley, the company's independent auditors must attest to the effectiveness of the company's system of internal control over financial reporting.

The Public Company Accounting Oversight Board (PCAOB), which regulates the public accounting firms, has put companies and auditors on notice that internal control over financial reporting extends beyond number-crunching to encompass controls over the *identification and assessment*, as well as the measurement and reporting of environmental liabilities. In order to eliminate environmental due diligence as an internal control consideration under Section 404 of Sarbanes-Oxley, management and the company's independent financial auditor must each conclude that the likelihood of material environmental liabilities arising from past, current, and future operations is *remote*.

Cascading Certifications

Sarbanes-Oxley is putting public companies under a microscope and the stakes for noncompliance are high. Corporate officers who knowingly and willfully issue misleading financial statements can receive a fine of up to $5 million, or a prison sentence of up to 20 years, or both. In addition, if the company is required to restate prior years' financial statements, these officers must repay any bonuses and gains on company stock sales they received during the affected period.

It is not surprising that C-Suite officers are seeking to push accountability for financial reporting down the organization chart — including the offices of corporate real estate managers. Following the reasoning of, "If I am going to jail, you're going with me," many top corporate executives are asking direct reports to sub-certify reported financial information within their purview. When business unit leaders and staff directors in turn ask their direct reports to sub-certify, there is a cascading series of certifications.

Undisclosed Environmental Liabilities

Corporate real estate managers can expect to be asked to sub-certify the company's reported real estate assets, liabilities, revenues, and expenses. In this regard, undisclosed environmental liabilities are of particular concern. Many commercial and industrial sites have known or suspected environmental contamination. Yet, environmental liabilities associated with company-owned properties and facilities are rarely reported in corporate financial statements.

For the past 25 years since the enactment of Superfund, U.S. companies have routinely sought to defer or avoid environmental cleanup costs by foregoing activities that might trigger regulatory scrutiny of company-

owned properties and facilities with known or suspected contamination. The practice, commonly known as "mothballing," is widely viewed to be permissible under federal and state environmental laws, which generally do not impose an affirmative duty to look for historical contamination. This has led companies to adopt a "don't ask, don't tell" strategy and to mothball properties with known or suspected contamination.

At the same time, generally accepted accounting principles have not required companies to report environmental liabilities for company-owned properties and facilities in the absence of pending or threatened legal action to compel cleanup. Mothballing has thus provided the dual benefits of deferring cleanup costs and keeping environmental liabilities off the books.

Asset Retirement Obligations

Starting in 2006, companies must report the fair value of environmental cleanup obligations on company-owned properties and facilities under a new far reaching accounting standard issued by the Financial Accounting Standards Board (FASB). Moreover, as noted previously, while environmental laws may not require companies to identify and assess historical pollution conditions impacting company-owned properties, the U.S. securities laws arguably now do.

On March 30, 2005, FASB issued an interpretation of a 2001 accounting standard, Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (FAS143). The Interpretation, FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47), clarifies that FAS 143 is applicable to so-called "conditional legal obligations," defined as a legal obligation to perform an asset retirement activity in which the timing or method of settlement are conditional on one or more future events that may or may not be within the control of the entity. Under FIN 47, AROs must be booked for future environmental cleanup obligations, *even if management has no current plans to retire the contaminated asset and believes it can defer settlement of such obligation indefinitely (e.g., by mothballing).*

Although FIN 47 applies to operating facilities as well as non-operating facilities, the change in accounting standards will especially affect the management strategy currently employed for hundreds of thousands of contaminated "brownfield" sites in the U.S that are now being mothballed. Furthermore, hardly any company with a significant real estate portfolio will be untouched, as the new standard applies to a wide range of environmental conditions, from soil and groundwater contamination to asbestos-containing building materials. In particular, companies can expect their financial auditors to pay increasing attention to unutilized and underutilized properties and facilities, as these properties are likely harbingers of undisclosed environmental liabilities.

Fair Value

Under FAS 143 and FIN 47, liabilities for environmental-related AROs must be recorded at their "fair value." Generally speaking, the fair value of a liability is the amount at which the liability could be settled in a current transaction between willing parties (other than in a forced or liquidation transaction). Market prices quoted in active markets are the best evidence of fair value. If quoted market prices are not available, fair value is estimated based on the best information available in the circumstances, including prices for similar liabilities and the results of expected present value (or other valuation) techniques. Fair value measurement requires significantly more data and analysis than the "best estimate" and "known minimum value" approaches previously used to estimate environmental remediation liabilities.

In the past, companies have been able to avoid calculating values if doing so required "undue cost and effort". In June 2005, FASB explicitly rejected this long-standing policy, stating that the "undue cost and effort" criterion should be eliminated because *"the most relevant valuation technique might also be the most costly valuation technique."* The practical consequence is that companies will have to design and implement new procedures to systematically identify and measure environmental cleanup and disposal obligations, thereby filling the valuation data gaps created by the mothballing strategy — regardless of cost and effort.

Impending Changes

Long-standing corporate real estate strategies can be expected to change significantly as a result of FIN 47. The days of deferring cleanup and disclosure of contaminated commercial and industrial sites by simply mothballing them, leaving the real estate department with responsibility for paying for taxes, utilities, insurance, and security, are over.

The requirement to identify, assess, measure, and report environmental cleanup obligations for company-owned properties and facilities will make it increasingly difficult and risky for public companies to keep environmental liabilities off the books. Moreover, the information generated by the company's internal control procedures (e.g., information confirming groundwater contamination) may trigger reporting obligations under environmental laws, thus effectively forcing the company to take

corrective action now instead of later. The dual benefits of mothballing will disappear and the practice will no longer be an effective management tool.

Gone are the good old days when corporate real estate managers could safely assume that responsibility for identifying, investigating, valuing, and reporting environmental liabilities rested with the company's attorneys and environmental engineers. The fact is that if you are certifying the company's real estate records, you may be held accountable for undisclosed environmental liabilities affecting the company's real estate portfolio, even if you were completely unaware of the circumstances. You act at your own peril if you certify without first gaining reasonable assurance that the records are complete and accurate.

Getting Prepared

Few companies have the procedures and controls in place needed to satisfy the rigorous internal control requirements of Sarbanes-Oxley when it comes to the identification, assessment, measurement, and reporting of environmental liabilities impacting company-owned properties and facilities (as opposed to non-owned disposal sites). Indeed, many large U.S. companies don't even have a complete inventory of their non-productive and surplus properties. The lack of controls may be complicated by a history of intentionally avoiding the investigation of such sites in order to defer or avoid cleanup costs.

Non-disclosure of environmental liabilities has the potential to become the next accounting scandal. If that happens, corporate real estate managers could get caught in the crossfire. Corporate real estate managers who have certified the accuracy of reported financial information will be implicated.

Designing and implementing an effective internal control system for FAS 143 and FIN 47 will require a multi-disciplinary team of environmental, real estate, accounting, valuation, and legal experts. Depending on the size and breadth of the company, the process can take from several weeks to several months, or longer. The time to get started is now.

Don't be lulled into thinking that environmental liabilities are someone else's job or that because mothballing has gone on for years that it is still okay. Your job and future security could be at stake.

A proactive plan of action for compliance with Sarbanes-Oxley involves three key activities: (1) develop an inventory of the company's operating and non-operating properties and improvements; (2) assess these properties for environmental AROs; and (3) develop a strategy for measuring and reporting AROs on properties.

The new valuations will trigger several secondary issues that must be managed, including regulatory, securities, tax, and risk management issues. For instance, the corporate legal and engineering departments need to be notified that a plan of action is needed for management of environmental liabilities and the business risks associated with them. The corporate real estate department must work closely with this team. A likely consequence is divestiture of non-productive, mothballed properties.

A Silver Lining?

For some companies, FIN 47 may prove to be a blessing in disguise. Today, cleanup costs are often far less than once feared due to the widespread adoption of innovative risk-based cleanup programs. Also, by divesting non-productive contaminated properties, companies can avoid the ongoing operating and maintenance costs of mothballing, while generating cash from the sale of the asset and avoiding the risk of future regulatory enforcement and litigation. By utilizing a comprehensive analysis of direct and indirect costs, effective environmental risk management techniques, and sound real estate practices, ridding the company of a legacy of environmentally impaired properties may prove to be far less painful than expected, and may even prove to be profitable. LEADER

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