

If Your Head Is in the Sand, Your Assets Are Exposed

by Greg Rogers

It is said that you cannot manage what you cannot measure. Might this axiom explain in part why U.S. corporations have for decades tended to fence off contaminated properties rather than seek to sell or redevelop them?

One thing is for sure; until recently, U.S. accounting standards have not encouraged corporations to measure and report brownfield asset values and liabilities. For those inclined to do so, generally accepted accounting principles (GAAP) have made it easy for corporations to ignore the contaminated sites in their real estate portfolios. Contaminated properties have traditionally been "missing in action" on U.S. corporate balance sheets. But that is starting to change.

A new accounting pronouncement that took effect in December 2005 is driving corporations to identify, assess, measure and report a broad range of environmental legal obligations associated with owned and leased properties having known or suspected environmental impairments. This new accounting standard comes in the wake of Sarbanes-Oxley and at a time when corporate financial reporting is subject to greatly increased scrutiny.

Today, if your head is in the sand, your assets are exposed. Together, FIN 47 and Sarbanes-Oxley promise to transform environmental financial reporting from MIA (missing in action) to WYSIWYG (what you see is what you get). The increased pressure for environmental transparency is already affecting the brownfield marketplace and more changes are sure to come.

Understanding FIN 47

Financial Accounting Standards Board (FASB) Interpretation No. 47 (FIN 47), Accounting for Conditional Asset Retirement Obligations (AROs), represents a revolutionary expansion in the scope of environmental obligations deemed to be "liabilities" under generally accepted accounting principles (GAAP). For the first time, legal obligations associated with the future retirement of property, plant and equipment are considered existing liabilities, even if the timing or method of settlement of these obligations is conditional on future events.

For example, the regulatory obligation to abate asbestos-containing materials (ACM) prior to demolishing a building must be reported as a liability

today, even though the owner of the building has no current plans to demolish the building. That is revolutionary!

FIN 47 is not limited to ACM. It applies to all AROs associated with the retirement (for purposes of FIN 47, the term "retirement" includes "sale" and "recycling," in addition to permanent removal from service) of tangible, long-lived assets and arising from the acquisition, construction or normal operation of the asset. AROs can potentially encompass a broad range of environmental cleanup, disposal and restoration obligations.

Companies must book an ARO as soon as they're responsible for it. If there's uncertainty involved — and there almost always is (for instance, when the building with ACM will be sold, recycled or demolished) — that uncertainty must be built into the "fair value" estimate of the obligation. FIN 47 favors early disclosure over certainty and precision.

It is still too early to assess the ultimate impact of FIN 47 on corporate income statements and balance sheets, but the effect thus far is drawing attention. As recently reported in Compliance Week, the adoption of FIN 47 in the fourth quarter of 2005 caused corporate America to collectively shave more than \$1 billion from its earnings — yet environmental and legal analysts say companies are still unsure about what to report and can expect to show even bigger losses in future disclosures.

So far, the cumulative effect of the adoption of FIN 47 has ranged from \$225,000 to \$251 million in reduced earnings for 2005. The impact on earnings per share has ranged from \$0.01 to \$0.26 per share. The balance sheet impact of reported AROs, however, in some cases is much greater.

Three utility companies have reported liabilities for AROs in excess of \$1 billion. One utility has reported AROs in excess of \$4 billion. In contrast, other industries with seemingly large environmental legacies and future cleanup

New GASB Standard for Environmental Liabilities

While public and non-public businesses are wrestling with FIN 47, the Government Accounting Standards Board (GASB) is developing a new accounting standard to "put the cost of cleaning up pollution on the financial statements of state and local governments." GASB released an exposure draft of the proposed standard in January 2006.

Notably, unlike FIN 47, the proposed standard does not require state and local governments to account for asset retirement obligations. Under the proposed standard, governments would not be required to search for pollution they may be responsible for cleaning up. But under certain circumstances, when a range of potential cleanup costs can be reasonably estimated, a liability must be reported.

Similar to FIN 47, the proposed GASB standard would require environmental liabilities to be measured using the expected cash flow measurement technique, which involves assigning probabilities or likelihoods to various cleanup scenarios and calculating a weighted average of them. According to GASB, the proposed standard would result in earlier recognition and higher estimates for many pollution remediation liabilities.

obligations have reported AROs that are hardly worth quantifying. This leads one to question what companies are considering to be an ARO (and what environmental conditions they are excluding) and whether they are correctly estimating the value of their identified AROs.

SEC filings show that many companies reporting AROs have accounted only for a limited scope of facilities-related obligations, such as abatement and removal costs for ACM and PCB transformers. In contrast, other companies have reported AROs for a broad range of facilities-related and real estate-based obligations, including closure costs for solid and hazardous waste management units and environmental restoration costs.

In accordance with SEC guidance, some companies have reclassified as ARO environmental liabilities previously recorded as loss contingencies under FASB Statement No. 5, while others are holding steadfastly to the argument that "if (government enforcement) is not probable, the liability is not reportable."

For the time being, inconsistency reins supreme. A recent survey by the Corporate Executive Board found that there is significant variability in how corporations are interpreting and implementing FIN 47:

- 1) The financial statement impact of FIN 47 varies widely across companies (for example, one company reported \$202 million as the cumulative effect of adopting FIN 47, while a comparable size company in the same industry reported "no material effect").
- 2) FIN 47 resource consumption varies widely across companies (for example, one company devoted 5,000 man hours to implementing FIN 47, while a comparable company devoted all of six hours to the effort).
- 3) Not all companies are estimating the value of their identified AROs.

When the Dust Settles

What kind of numbers might we expect to see on corporate balance sheets some day in the future when the dust settles? A 2004 EPA study provides some jaw-dropping possibilities. EPA estimates that it will cost \$209 billion to clean up 294,000 hazardous waste sites between now and 2033, \$128 billion to clean up 45,000 manufactured gas plant sites, \$29 to \$54 billion to clean up hard rock mine sites, and \$6.3 billion to clean up dry cleaner sites.

Faced with the prospect of reporting previously undisclosed environmental cleanup, disposal, and restoration obligations — especially with respect to non-productive assets — corporations are now considering alternatives to their long-held risk management strategies. For example:

- More and more corporations are choosing to divest their non-productive and fenced off properties. Industry insiders report a marked increase in divestitures of real estate since FIN 47 took effect in December. Expect this trend to continue into the future.
 - Some companies are executing sale-leasebacks of operating sites as a way to move environmental AROs to the buyer-lessor's balance sheet.
 - Some companies are choosing to clean up and redevelop their own mothballed sites, preferring to maintain control over long-term land use as a means of limiting future liability exposure.
- Other creative strategies are sure to come if the impact of FIN 47 continues to expand. In the meantime, most companies will likely continue to stay on the sidelines until the accountants, lawyers and regulators figure out who, if anyone, got it right in the first round of FIN 47. **BFN**

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