Preparing Yourself for New Rules for Environmentally Impaired Property

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NEW FINANCIAL ACCOUNTING RULES AND REPORTING LAWS ARE CREATING HAZARDS, AS WELL AS OPPORTUNITIES, FOR APPRAISERS. You might soon be asked to provide appraisals of property with known or suspected pollution cleanup liabilities. If your appraisal implicitly, or explicitly, includes valuation of the liability, you might be subject to the rules and penalties of Sarbanes-Oxley.

The Public 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 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 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.

Corporate officers who knowingly and willfully make false claims and issue misleading financial statements can receive a fine of up to $5 million, a prison sentence of up to 20 years, or both. These officers must repay any bonuses they received during the period for which financial statements must be restated.

As a result, the C-suite officers are seeking to push accountability for financial reporting down the organization chart by asking direct reports to sub-certify portions of the financial statements within their purview, which creates a cascading series of certifications.

FASB's FIN-47

Under the Financial Accounting Standards Board Interpretation No. 47 (FIN-47), Accounting for Conditional Asset Retirement Obligations, companies are required to identify and report pollution cleanup liabilities even if they are not currently under a regulatory enforcement action. In addition, FIN-47 also requires liabilities for asset retirement obligations (ARO) to be valued at fair value. The fair value of environmental AROs generally will be estimated using expected present-value techniques that incorporate cash flow information and rigorous best-engineering practices.

FIN-47, which became effective December 15, 2005, is FASB's interpretation of its Statement No. 143 (FAS-143), Accounting for Asset Retirement Obligations.

FAS-144

AROs are to be booked as a liability and simultaneously as an asset reserve of an equal amount. This results in no net difference to the balance sheet. But this requires calculation of a recoverability test under FAS-144, Accounting for the Impairment or Disposal of Long-Lived Assets, issued in August 2001. The recoverability test determines whether the asset is capable of generating sufficient cash to pay for the liability.

Operating assets (e.g., factory, store, office building) generate current and future positive cash flows. Therefore, operating assets will rarely fail the recoverability test. Whenever the "recoverable amount" of an asset is less than its "carrying amount" (sometimes called the "book value"), an "impairment loss" will be recognized. Conversely, non-operating assets (brownfields) do not generate cash inflows and are far more likely to fail the recoverability test. If the recoverability test indicates impairment, FAS-144 requires the impaired asset to be written down to its fair value.

Implications for you

It is unlikely that appraisers will be asked to value environmental AROs because this process does not include valuation of the associated asset. However, it is foreseeable that accounting for AROs under FAS-144 will or should trigger the write-down of many contaminated properties. Accounting for environmentally impaired assets will require appraisers to evaluate the impact of environmental conditions on the current market value of the property. This might carry significant bottom-line issues for you and your clients that you have not encountered in the past.

Most appraisals prepared today have environmental disclaimers in which the appraiser claims no knowledge of environmental conditions and states that the appraisal of the property is made as "clean." This disclaimer would be inappropriate for FAS-144 valuation assignments triggered by an environmental ARO or other environmental condition.

In today's world of appraising for corporate clients, the general environmental disclaimer, used extensively by appraisers for the past 20 years, might be obsolete. Appraisers are advised to replace the general disclaimer and environmental assumptions with specific environmental questions when assessing

assignment conditions. Answers to these questions will lead the appraiser to prepare extraordinary assumptions, hypothetical conditions and a scope of work needed for credible opinions. A more precise development of assignment conditions will help the appraiser avoid being an inadvertent participant in the financial reporting process.

If you decide to accept these assignments, you must recognize that proper coordination of these issues requires organization of a team with multidisciplinary expertise. Auditing expertise is needed to ensure that proper financial reporting valuation techniques are employed. Legal expertise is needed to identify and evaluate environmental legal obligations, and environmental professionals are needed to prepare engineering cost estimates.

Plan of action

When appraising a property known to have environmental issues as if "clean" or unimpaired, a hypothetical condition exists – specifically, a condition known not to be true but assumed to be true for the appraisal.

An appraisal that utilizes the expertise of other experts to assist in the development of a value opinion (either environmental, legal or FASB-related) will likely invoke an extraordinary assumption. The appraisal is based on conditions that are assumed to be true but if found in the future would affect the value of the opinion.

Even if you choose not to offer this service, you owe it to your clients and prospective clients who are confronted with these issues to adequately explain the situation to them. You will also want to be able to direct them to sources of help.

Competent appraisers need not be discouraged from accepting assignments on properties that might have environmental issues. These assignments can be seen as opportunities. The task ahead is for appraisers to hone their skills and prepare for a meaningful future of asset valuation in light of new financial reporting requirements. ■

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