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Insider's View

Laws, rulings force manufacturers to alter their accounting practices

Pittsburgh Business Times - November 24, 2006 by Patrick Zaepfel

The Sarbanes-Oxley Act forced publicly traded companies to take a hard look at their accounting practices and financial assumptions, but an evolution that is taking place in the labyrinthine world of accounting may have an even greater impact on manufacturers -- their bottom lines.

Since SOX was enacted, accountants have aggressively sought to develop new ways to quantify business and legal risks in order to provide more precise and accurate disclosures to the investing public. Recent changes in financial accounting standards (aka Generally Accepted Accounting Principles) are sharpening the lines between the accounting performed for two sorts of risks, namely contingent liabilities and contingent retirement of assets.

Once these accounting theories converge, manufacturers and others with Carnegie-era facilities or extensive environmental liabilities may face stunningly large hits to their balance sheets.

In March, the Financial Accounting Standards Board issued an interpretation to clarify when to account for conditional asset retirement obligations. This interpretation, entitled FASB Interpretation No. 47, states that companies must book these costs when the obligation itself is incurred, not when the act of retiring the asset is undertaken.

FASB generally presumes that all assets will eventually be taken out of service or otherwise disposed or recycled. A "retirement" includes the asset's sale, abandonment, recycling or disposal in some other manner. A retirement is conditional if the timing and/or the method of retirement depends on a future event that may or may not be within the control of the company.

FIN 47 clarifies that a company must recognize a liability for the fair value of the asset retirement obligation when that obligation is incurred if the liability's fair value can be reasonably estimated, even if it has to be probability weighted.

FIN 47's use of "fair value" estimates for asset retirement contrasts with older accounting principles regarding accounting for contingent liabilities. Under these principles, contingent liabilities -- which are charged against income only if they are material, probable and estimable -- are measured at their most likely value. If a single most likely outcome is not reasonably estimable, then the contingency is valued at the low end of the range of possible outcomes.

In September, FASB issued Statement of Financial Accounting Standards No. 157, an accounting statement that specifies how to determine fair value.

Under FAS 157, which generally takes effect for fiscal years starting after Nov. 15, 2007, fair value is determined by reference to objective market pricing schemes that quantify the risk posed by the contingent obligations, such as insurance or other liability transfer mechanisms.

If no such market currently exists, the company is to predict what a market participant would pay if in fact there were a market. While FAS 157 gives guidance on the subject, putting a price on something that is not even for sale is inherently troublesome, especially when perception of risk dramatically changes the outcome.

So when a manufacturer owns and operates a factory with legacy contamination, asbestos and the like, is it faced with a contingent asset retirement obligation or a contingent liability?

FIN 47 states that it does not apply to remediation obligations that arise due to "improper" operation of an asset. Many impaired assets, however, were not illegally operated at the time of impairment, but statutory liability is nevertheless strictly applied. Further confusing the situation, FIN 47 applies to any obligation to retire an asset, including even contested contractual obligations.

These artificial distinctions and logical inconsistencies may soon be fossils of accounting evolution.

In light of developments under way with FASB in the U.S. and the International Accounting Standards Board in the European Union, Greg Rogers, author of "Financial Reporting of Environmental Liabilities and Risks after Sarbanes-Oxley," predicts that eventually all environmental liabilities will be measured at fair value.

"Companies should be preparing for the significant implications of fair value measurement now," says Rogers.

In the aftermath of this sea change, accounting and legal advisors will have to respond to the implications of "fair value" charges on their financial statements and in their disclosures.

Manufacturers will in turn be challenged to explain the accounting rhetoric to the investing public, which will be no easy task.

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