

An Expert Analysis

New Accounting Rules To Affect Environmental Due Diligence And Increase The Profile Of Environmental Experts

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In December 2007, FASB issued a revision to Financial Accounting Statement No.141 (FAS-141R) for Business Combinations. Business combinations include nearly all business mergers and acquisitions. FAS-141R, which will become effective on December 15, 2008, requires that a buyer recognize all assets and liabilities (including contingent environmental liabilities) in a transaction at the "Fair Value." A previous FASB pronouncement, FAS 157 Fair Value Measurements, issued in December 2006, sets the framework for measuring fair value.



The manner in which liabilities must be recognized under FAS 141R and FAS 157

are a far departure from the way environmental liabilities were historically recognized in business combinations. The differences between the historical recognition criteria and the new criteria are summarized in Table 1. Under the old FAS 141, accounting recognition of environmental liabilities could be deferred until the recognition criteria for FAS 5, Accounting for Contingencies, were met. FAS 5 requires recognition of a liability only if (1) the loss is "probable," meaning it is highly likely to occur and (2) can be reasonably estimated. If a contingent environmental liability did not meet either of these requirements it did not need to be recognized on accounting statements or for business combinations. The new FAS 141R will require that environmental liabilities be recognized at the fair value as of the acquisition date. In addition,

liabilities on their books as of the transaction date. This will necessitate more careful due diligence concerning the environmental liabilities that will be assumed. Sellers also need to be cognizant of the new rules. Before proceeding with any transaction, sellers should get a good handle on the fair value assessment of their environmental liabilities to aid in negotiations and to avoid being surprised by issues that could derail the deal.

Environmental Experts may need to evaluate and answer any number of the following questions on any given deal:

- For each REC, or for the property in general, what is the likelihood that an environmental investigation or remediation will be necessary?
- What remediation technologies are potentially applicable to the contaminants?
- What will the regulators likely approve? Is there a possibility that fines or penalties could be levied by regulators?
- What is the range of potential outcomes? What are the estimated costs for each potential outcome? And what is the probability of each outcome occurring?
- What is the statistical "expected value" for the liability?
- Is there a possibility of natural resource damages (NRD) being assessed?
- Are there potential third party liabilities? (e.g. off-site impacts or toxic torts)
- For all identified liabilities, are they "more likely than not" to occur?

different recognition criteria will apply depending on whether the contingencies stem from contractual or non-contractual obligations. All contractual contingencies must be recognized at fair value as of the acquisition date. Contractual agreements would include items such as indemnity agreements and liabilities as a Superfund PRP. Non-contractual contingencies will only need to be recognized if it is "more likely than not", as of the acquisition date, i.e., there is a 51% or greater likelihood of a liability.

Uncertainty as to the occurrence and amount of a liability will no longer be a valid reason to defer accounting recognition of contingent environmental liabilities in M&A deals. FAS 157 allows for the use of statistical probability analysis to determine the "expected fair value" measurement for contingent liabilities. Looking further to the future it is likely that FAS 5 will be revised as well to incorporate fair value measurements of existing contingent liabilities. The end result will be a significant increase in the number of contingent environmental liabilities that will need to be recognized in corporate accounting statements.

The most obvious implication of the new accounting pronouncements is for buyers who must now recognize contingent

In order to provide the lowest possible defensible estimate of environmental liabilities, experts will need to have a variety of capabilities in their tool box including the ability to implement Triad investigation approaches where it is necessary to quickly evaluate the extent and magnitude of contamination in order to provide fair value cost estimates within the allowable due diligence time frame; expertise in the use of new and innovative remediation technologies which can reduce environmental remediation costs; command of statistical approaches and the latest cost modeling tools; experience in the procurement of government grants, insurance products and insurance recovery which can be used to off-set environmental liabilities; and the ability to conduct up-front negotiations with regulators to obtain acceptance in concept of a proposed remedial approach.

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