Environmental liabilities go to market

Greg Rogers considers how market-based valuation of environmental liabilities will begin to impact business mergers and acquisitions

Environmental reporting in mergers and acquisitions (M&A) is about to get tougher. New standards for M&A deals, issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), abandon the long-standing rules for recognising and measuring contingent liabilities in favour of fair value measurement, also known as mark-to-market. Instead of booking only amounts that are nearly certain to be spent to settle a contingent liability, acquiring companies will soon be required to report the market value of the obligation, uncertainties and all.

Beginning in 2009, public and private companies seeking to report to FASB or IASB standards must recognise liabilities for all material contract-related contingencies (eg, environmental indemnities previously granted by the seller) assumed in a merger or business acquisition. Acquirers must recognise liabilities for material non-contractual contingencies (eg, pending and unasserted claims) if it is "more likely than not" that a liability exists as of the acquisition date. All recognised liabilities must be recorded at their acquisition-date fair value.

The fair value of a liability is the price that would be paid to transfer the liability in an orderly transaction between market participants at the measurement date (exit price). A quoted price for the identical liability in an active market is the best evidence of fair value. If an active market does not exist, companies must estimate the exit price based on the assumptions that market participants would use in pricing the liability.

To understand how fair value measurement will affect environmental contingencies in M&A deals, consider the following hypothetical example.

Company A plans to purchase the stock of Company B. Due diligence shows that Company B sold a manufacturing facility in 2001 and gave the current owner an unlimited contractual indemnity for third-party claims arising from pre-existing contamination. The new owner later discovered soil and groundwater contamination resulting from historical releases of trichloroethylene (TCE) caused by Company B. Based on limited investigation, it is known that TCE-contaminated groundwater has migrated offsite under a residential neighbourhood at concentrations posing a risk of harm to human health from toxic vapours leaking into homes.

At the time of the acquisition, no third-party claims have been asserted. Company B, however, has agreed to pay for a thorough environmental assessment, which it estimates will

Where's fair value for environmental remediation?

cost $250,000. Depending on the extent of contamination, clean-up costs are expected to range between $2 million and $10 million. In accordance with applicable accounting standards, Company B has used the reasonably estimable cost of the investigation as a surrogate for the known minimum value of the total cleanup and unasserted third-party claims, and booked a contingent liability in the amount of $250,000.

Company A's lawyers and accountants conclude that the indemnity is a material contractual contingency that must be recognised as a liability at its acquisition-date fair value. In determining market value, Company A divides the liability into two components: the obligation under environmental laws to clean up the contamination and unasserted third-party claims for property damage and bodily injury.

Based on available information, Company A estimates that it would charge $5 million to assume Company B's clean-up liability in a stand-alone transaction. This estimate is comparable to a quote obtained from an environmental remediation firm that specialises in liability buy-outs.

Considering possible outcomes of potential litigation, including a possible out-of-court settlement, Company A's counsel estimates a loss of $100 million as the reasonable worst-case outcome for bodily injury and property damage claims. Company B obtains a quote in the amount of $10 million for a 10-year, $100 million environmental insurance policy that would respond in the event of third-party claims for bodily injury or property damage.

Upon the acquisition, Company A records a contingent liability in the amount of $15 million – $5 million for clean-up costs plus the insurance premium quote for bodily injury and property damage coverage – as its estimate of the acquisition-date fair value of the seller's contractual indemnity obligation.

As this example illustrates, fair value measurement of environmental liabilities in business combinations can be expected to result in more booked liabilities and higher, sometimes much higher, estimates. In addition, the new standards require companies to provide more disclosures about acquired contingencies, including the nature and amount of the contingencies and the potential range of outcomes, which could prejudice a company's ability to avoid litigation or settle pending claims. These changes will increase the visibility and importance of environmental contingencies in M&A transactions, and are likely to cause friction among buyers, sellers and lenders.

The new standards also change prior practice for recording measurement period adjustments. Instead of recognising changes to provisional amounts prospectively as a change in estimate, acquirers must revise comparative information for prior periods. This requirement will increase the pressure on due diligence to enable timely and accurate market-based estimates and thereby minimise the need to revise prior-period financial statements in subsequent filings.

In conclusion, new US and international accounting standards will dramatically affect how environmental and other contingencies are recognised and measured in business mergers and acquisitions. Many environmental contingencies that are not considered probable and reasonably estimable under traditional practice will be subject to recognition. Moreover, market-based valuations often will far exceed the known minimum value estimates now on the books of sellers.

The result will be more recorded liabilities at higher values. Adding to the substantial challenge of establishing new due diligence and valuation procedures to generate market-based estimates, acquirers and their attorneys, accountants, and consultants will be under intense pressure to get it right the first time in order to avoid future restatements. EF

Greg Rogers is president of Texas-based Advanced Environmental Dimensions and author of Financial Reporting of Environmental Liabilities and Risks after Sarbanes–Oxley *(Wiley 2005). E-mail: rogers@fin47.com*