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Your tough SFAS 141(R) questions answered by EHS Support partner & accounting experts Alpern Rosenthal

EHS Support, Alpern Rosenthal, and Egan & Associates recently published a newsletter summarizing the new SFAS 141(R) accounting standards.

Response to the newsletter was immediate and our clients asked many detailed and technical follow up questions to get themselves prepared for these industry and sector wide changes that will affect conducting merger, acquisition, joint venture, and divestiture activities.

EHS Support collaborated with Jeff Kovacs, shareholder with Alpern Rosenthal, to follow up on these key questions regarding the new standard and how it relates to our environmental clients.

Is there a threshold that needs to be exceeded before a liability is required to be quantified, i.e., how is materiality defined?

Materiality is defined by the FASB as the magnitude of an omission or misstatement in the financial statements that makes it probable that a reasonable person relying on the financial statements would have been influenced by the omitted information or made a different judgment if the correct information had been known. Therefore, there is no definitive guidance in distinguishing material information from immaterial information. Professional judgment must be exercised in evaluating information and concluding on its immateriality.

Are there any required or recommended valuation methods?

The valuation methods will vary depending on the nature of the contingency. All valuation methods must conform to the requirements of FAS 157, Fair Value Measurements. FAS 157 defines fair value and establishes a GAAP framework for measuring fair value. The definition of fair value retains the exchange price aspect present in a number of earlier definitions of fair value, but emphasizes the exit price (price received to sell the asset or paid to transfer the liability) instead of the entry price (paid to acquire the asset or received to assume the liability). Consequently, fair value is a market-based measurement, not an entity-specific measurement, thus assumptions about the market participant should include assumptions about the effect of a restriction on the sale or use of an asset. FAS 157 permits valuation techniques consistent with the market approach, income approach, and/or cost approach. However, FASB Staff Position No. FAS 157-2 defers the effective date of FAS 157 for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of FSP FAS 157-2, which includes FAS 144.

The fair value measurement should consider unique attributes of the asset or liability and must assume the highest and best use of the asset by market participants. For example, if a reporting entity desired to sell contaminated land, the fair value measurement should consider the condition and any restrictions on the use of the land at the measurement date. Contaminated land often is burdened by a restriction on the seller to remediate prior to transfer or a promise on the part of the buyer to remediate after transfer. The highest and best use of the land might be to remediate the property only to the extent it could be used as a brownfield (*i.e.*, limited, protected, or industrial use) or to remediate fully to greenfield (*i.e.*, clean) status. EHS Support's proprietary risk quantification model can quickly and accurately quantify the fair value of contingent liabilities associated with mergers and acquisitions.

SFAS 141(R) Questions and Answers

Will the quantified values developed during the due diligence be used as the reserve or 10K values reported to the SEC after the deal is completed? Does this differ at all for privately held companies that follow GAAP?

Quantified values developed during due diligence will be used as a starting point for evaluating the fair value of any environmental liability assumed in an acquisition accounted for under SFAS 141(R). These values must be evaluated and a final value determined for the reserve for any financial reporting event including a 10k filing after the deal is complete.

The fair value measurement approach appears to favor (market-based) projections over certainty of occurrence. It seems this will accelerate recognition of contingent liabilities, causing previously off-balance sheet liabilities onto the financial statements. In other words using a FAS 5 approach historically companies would not have immediately recognized certain "potential" environmental liabilities, however the fair value approach required by 141(R) will require immediate recognition of the liability. Does this indicate that over time the FAS 5 approach will no longer be used to address environmental liabilities? This has the potential for a significant impact in the short term because the market-based estimates of the exit price for a contingent liability can be higher (sometimes significantly higher) than estimates produced under FIN 14 and SOP 96-1.

The fair value measurements of SFAS 157 will apply to any contractual environmental liability assumed and accounted for in accordance with SFAS 141(R). In addition, when a non-contractual liability is assumed and it is more likely than not that a liability has been incurred, the fair value measurements will apply. Therefore, there will definitely be an increase in the number of liabilities recorded. In those instances where it is not more likely than not that a non-contractual liability has been incurred, the provisions of SFAS 5 can be applied.

The primary difference will be that the liabilities accounted for at fair value will most certainly result in a single point amount that is higher than the lower amount of a range of amounts that might have been determined in accordance with SOP 96-1 and FIN 14.

For companies that utilize FAS 5 and SOP-96-1 exclusively – will 141(R) cause any need or requirement to shift to an asset retirement obligation approach for all reserves?

SFAS 141 (R) focuses on the accounting for acquired contingencies, generally at fair value. These contingencies may consist of environmental contingencies, asset retirement obligations covered by contract or law or any other type of contingency. Therefore, there will not be a shift toward an asset retirement obligation approach for all reserves. Each type of contingency assumed at acquisition will need to be evaluated at the acquisition date and the fair value determined. There will still be a need for the use of SFAS 5 and SOP 96-1 for those acquired non-contractual contingencies that do not meet the more likely than not threshold.

SFAS 141(R) Questions and Answers

When reviewing the SFAS 141(R) standard it appears the acquirer must report environmental liabilities, at market value. It also indicates the new standard will require recognition of environmental cleanup obligations without regard to the likelihood of government enforcement or the probability that the company will ever spend money to clean up the site. Whereas existing FAS 5 does not require recognition of liabilities that cannot be "reasonably estimated," the new standard assumes that any contingency, no matter how uncertain, has a market value. Is this assessment correct?

This assessment is generally correct with one consideration. Environmental cleanup obligations that are non-contractually enforceable would result in a liability that must meet the more-likely than not threshold. This threshold is defined as the likelihood that the contingency gives rise to a liability, of any magnitude. Therefore, the burden of proof would be on the acquirer to support the assertion that a liability has not been created. I believe in most instances this will be a difficult assertion to support.

Does this standard open up companies to claims of being "environmentally insolvent"? I have seen this issue mentioned but how realistic is this type of claim?

When applying the accounting methodology under SFAS 141(R), in many cases, the enterprise value of the entity acquired, that transfers the environmental liability, should take this potential liability into account. I believe that the enterprise values of acquired entities will decrease as a result of good due diligence which calculates the fair values of the liabilities. Therefore, while environmental insolvency is always a possibility, it seems to me that the market forces at play in the negotiation will mitigate this risk.

How do you define the differences in the disclosure and booking of an accrual recognized as a contingent liability under FAS 141(R), specifically how does the one year provisional period impact the disclosures versus how it impacts the booking of a contingent liability?

FAS 141(R) requires that the contingent liability be accrued and disclosed as of the acquisition date. This means that companies must record a provisional liability in their financial statements for any periods subsequent to the date of the transaction. However, because companies need time to gather all of the necessary information to arrive at a final amount (i.e. obtain appraisals, calculations reports, etc.) the accounting rules allow for this provisional amount to be adjusted up or down in periods subsequent to the acquisition date. All adjustments have to have been recorded within one year, at which time the final amount has to be determined and no more adjustments are required. These up and down adjustments will, in most cases, affect the recorded values of other assets such as goodwill and may impact the income statement only to the extent that the amortization or depreciation of these other assets has taken place.

Therefore the acquirer must revise prior period financial information when reissued in subsequent financial statements. During the measurement period, the acquirer will retrospectively adjust the provisional amounts recognized at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date. During the measurement period, the acquirer also will recognize additional assets or liabilities if new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of those assets and liabilities as of that date. *Continued on page 4*

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The measurement period ends as soon as the acquirer receives the information it was seeking about the facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable.

New information that gives rise to a measurement period adjustment should relate to events or circumstances existing at the acquisition date. Factors to consider in determining whether new information obtained gives rise to a measurement period adjustment includes the timing of the receipt of new information and whether the acquirer can identify a reason for the measurement period adjustment. Information obtained shortly after the acquisition date is more likely to reflect facts and circumstances existing at the acquisition date, as opposed to information received several months later. Comparative prior period information included in subsequent financial statements is revised to include the effect of the measurement period adjustment as if the accounting for the business combination had been completed on the acquisition date.

The retrospective nature of measurement period adjustments has implications for SEC registrants. For example, assume a company reporting under U.S. GAAP with a calendar yearend acquires an entity on November 1, 2009, and on April 30, 2010 new information related to facts that existed at the acquisition date arises that leads to a measurement period adjustment. The company has already filed its Form 10-K for the year ended December 2009 and a Form 10-Q for the quarterly period ended March 2010.

The company must take the following actions to properly file its June 2010 Form 10-Q:

- Retrospectively adjust the December 2009 balance sheet
- Adjust the six-month income statements and the six-month cash flow statements for the periods ending June 2010 to reflect the retrospective adjustment
- Disclose the nature and amount of the measurement period adjustment

The company also must perform the following to properly reflect the subsequent adjustments of the provisional amounts in the December 2010 Form 10-K

- Retrospectively adjust the December 2009 balance sheet
- Retrospectively adjust the income statement, statement of changes in shareholders' equity, and cash flow statement for the year ended December 2009
- Retrospectively adjust the 2009 amounts in the selected financial data section and in the MD&A
- Retrospectively adjust the Selected Quarterly Data in the footnotes to the financial statements for the quarterly periods ended December 2009 and March 2010
- Disclose the nature and amount of the measurement period adjustment.

If you have any further questions, please contact:
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