PUBLIC SECTOR ACCOUNTING BOARD

PSAB CCSP

CONSEIL SUR LA COMPTABILITÉ DANS LE SECTEUR PUBLIC

Asset Retirement Obligations

Issues Analysis

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Introduction

.01 This Issues Analysis is a supporting document to the Public Sector Accounting Board's (PSAB) Exposure Draft, "Asset Retirement Obligations." It provides information on how significant matters arising from comments received on PSAB's Statement of Principles, "Retirement Obligations," have been dealt with in the Exposure Draft. Among other matters, it addresses:

(a) alternative views on the issues dealt with in the proposed standard; and

(b) the view taken by the Board, with appropriate reasons for taking that position.

.02 The analysis is not issued under the authority of PSAB. Prior to approving the final standard, the Board will review and deliberate responses to the Exposure Draft.

Background

.03 PSAB issued a Statement of Principles in August 2014. Respondents were generally supportive of the proposed principles on asset retirement obligations and welcomed a standard that provides specific guidance on this subject.

.04 Main issues raised by respondents to the Statement of Principles included:

(a) accounting for the debit balance;

(b) treatment of asset retirement costs associated with fully amortized, non-depreciable and unrecognized tangible capital assets;

(c) scope of the proposal;

(d) accounting for asset retirement obligations at the component versus network level; and

(e) recording of recovery.

.05 Respondents have also provided valuable input on the measurement and disclosure requirements, transitional provisions, as well as general comments that helped in further clarifying the proposal.

Accounting for the debit balance

.06 Principle 2 in the Statement of Principles proposed that asset retirement costs be capitalized. Although the majority of respondents agreed with this approach, some were concerned that it allows for smoothing of expenses and results in capitalization of costs that have no future value. Further, among those respondents who agreed with capitalization, some believe this approach may present issues with the impairment assessment. The concern is that the existing impairment guidance in the CPA Canada Public Sector Accounting (PSA) Handbook does not consider capitalization of asset retirement costs, which may lead to potential overstatement of assets.

.07 Given the respondents' arguments, PSAB has reconsidered how to account for asset retirement obligations associated with tangible capital assets in productive use. Five alternative approaches to capitalization, some of which were put forward by respondents, were reviewed by considering their impact on accountability and decision-making, consistency with the PSA Handbook, consistency with other standard setters and consensus:

(a) Recognize all retirement costs as an expense.

(b) Recognize retirement costs incrementally as a liability and an expense over the useful life of the related tangible capital asset.

(c) Present retirement obligations net of the related capitalized asset retirement cost.

(d) Recognize asset retirement costs as deferred outflows of resources.

(e) Capitalize asset retirement costs directly attributable to acquisition, construction or development, and expense those related to normal use.

.08 PSAB is of the view that the deferred outflow of resources approach would not fit the current conceptual framework. Recognizing the asset retirement obligation net of the related capitalized asset retirement cost would result in a lack of transparency. The expense approach, although conceptually sound, may result in a lack of consensus and is not supported by the work of other standard setters. The incremental recognition of liability is a viable approach supported by the work of the U.S. Federal Accounting Standards Advisory Board and consistent with the approach taken in SOLID WASTE LANDFILL CLOSURE AND POST-CLOSURE LIABILITY, Section PS 3270. However, this approach would result in an understatement of liability as liability is recognized incrementally based on use rather than as incurred.

.09 Capitalizing asset retirement costs directly attributable to acquisition, construction or development, and expensing those related to normal use was considered to be a viable option. This alternative is consistent with the definition of cost in TANGIBLE CAPITAL ASSETS, Section PS 3150. It better supports the notion that asset retirement costs directly attributable to acquisition, construction or development are no different from other costs that have or will be incurred to prepare the tangible capital asset for its intended use. Further, expensing costs directly attributable to normal use is consistent with the accounting treatment in Section PS 3270. This alternative also mitigates the risk of overvaluing assets and distorting their true service value, a concern raised by respondents.

.10 Although this approach provides many benefits, PSAB was concerned that it would result in debates over the types of costs qualifying for capitalization versus needing to be expensed. The Board also believes this option would add complexity, may not be practical and may result in inconsistency with the guidance of some of the other standard setters.

.11 PSAB concluded that capitalization of asset retirement costs associated with tangible capital assets in productive use is the most suitable alternative for the following reasons:

(a) Asset retirement costs are necessary and integral to owning and operating a tangible capital asset.

(b) Asset retirement costs are not a separate asset because there is no specific and separate future economic benefit that results from them. The future economic benefit of these costs lies in the productive asset that is used in the public sector entity's operations.

(c) Capitalization provides useful information for accountability and decision-making.

(d) Capitalization is consistent with the approach of the International Public Sector Accounting Standards Board, the Accounting Standards Board, International Accounting Standards Board and the U.S. Financial Accounting Standards Board.

(e) Capitalization has been supported by the majority of respondents.

.12 PSAB agrees with respondents that separate guidance on impairment outside of this proposed standard would be best suited to address the impairment issue.

Obligations associated with asbestos removal

.13 Two respondents disagreed with the treatment of asbestos removal in paragraph 38 of the Statement of Principles. In their opinion, there is no liability until the entity decides to renovate because existing regulations do not require asbestos to be removed unless the area is disturbed.

.14 Asbestos is strictly regulated in all jurisdictions in Canada. Those regulations require the removal and disposal of asbestos in a prescribed manner. As demonstrated in the Statement of Principles and further explained in the

Exposure Draft, the obligating event is not the disturbance of asbestos but rather the acquisition, development or construction of the tangible capital asset containing asbestos. This is because the entity has a legal obligation to remove and dispose of asbestos when acquiring, constructing or developing the tangible capital asset. The ability to defer settlement does not relieve the entity of the obligation. The asbestos will eventually need to be removed and disposed of because the tangible capital asset containing asbestos will not last forever.

.15 Uncertainty about the timing of settlement of the asset retirement obligation does not remove that obligation from the scope of these proposals but may affect the measurement of the liability for that obligation. This may require the use of professional judgment and be supplemented by experience, third party quotes and, in some cases, reports of independent experts. Uncertainties affecting the measurement of a liability for an asset retirement obligation are disclosed in accordance with MEASUREMENT UNCERTAINTY, Section PS 2130.

Fully amortized, non-depreciable and unrecognized tangible capital assets

.16 Respondents asked PSAB to clarify the treatment of asset retirement cost associated with fully amortized, non-depreciable and unrecorded tangible capital assets.

.17 An asset retirement obligation may exist in connection with a fully amortized tangible capital asset that is still in productive use. The Board considered three accounting options to account for these costs:

(a) Increase the tangible capital asset by the amount of the asset retirement cost and amortize the cost over the remaining useful life of the tangible capital asset.

(b) Adjust the opening balance of the tangible capital asset and the related accumulated amortization.

(c) Re-estimate the useful life of the tangible capital asset and treat the adjustment as a correction of an error as described in ACCOUNTING CHANGES, Section PS 2120.

.18 The second option is considered to be inappropriate given that the statement of financial performance would not be affected by the adjustment (direct credit to accumulated amortization rather than amortization expense).

.19 The third option may be viable, but potentially difficult to apply in certain situations such as when the public sector entity assumes a tangible capital asset with no costing history. Further, this option would only apply if the entity determines that the correction is a result of an error rather than a change in estimate.

.20 PSAB considers the first option to be most appropriate. It is consistent with the principle that the asset retirement costs, in conjunction with the historical cost of the tangible capital asset, form the full cost of the asset. This option is also consistent with the accounting for a change in estimate as described in ACCOUNTING CHANGES, Section PS 2120. It is also more practical than option three and more transparent than option two.

.21 An asset retirement obligation may exist in connection with an unrecognized tangible capital asset that is still in productive use. PSAB is of the view that these costs would be expensed as there is no historical cost basis to which the asset retirement costs could be attached. This treatment is consistent with the principle that it is the asset retirement costs together with the historical cost basis of the tangible capital asset that provide the service potential. Asset retirement costs, on their own, do not.

.22 PSAB was asked to provide guidance on asset retirement obligations associated with non-depreciable tangible capital assets. The Board could not identify examples of this situation. The examples considered were of asset retirement obligations related to a non-depreciable tangible capital asset but associated with a separate depreciable asset. For instance, landfill improvements may be required to use land for storage purposes. In this case, the asset retirement obligation would be associated with the landfill improvements rather than with the land. Given that useful examples were not identified, specific guidance on this topic has not been provided. The general principles on recognition and allocation of asset retirement obligations would be applied.

Scope

.23 The majority of respondents agreed that a liability for an asset retirement obligation should be recognized when there is a legal, constructive or equitable obligation. However, some respondents were of the view that determining whether a constructive or equitable obligation has arisen is very subjective. They believe there is a lack of clarity of how a constructive or equitable obligation related to retirement of an asset could be created by the government without a legal agreement or legislation. These respondents encouraged PSAB to limit the scope of the proposed standard to legal obligations only.

.24 PSAB believes that consistency in guidance within the PSA Handbook is important and that limiting the scope to legal obligations may lead to an understatement of liabilities. Having to exercise professional judgment is also not an argument for not recording constructive and equitable obligations. However, PSAB could not identify examples of constructive or equitable asset retirement obligations to be dealt with by the proposed standard. It also could not see how guidance could be developed that would assist public sector entities applying the standard in distinguishing constructive or equitable obligations from management intentions. Consideration was given to the effects of the lack of useful guidance in this regard. This may create preparer and auditor debates on whether a liability exists and result in unnecessary work. Consequently, PSAB limited the scope to legal obligations including those that arise from the exercise of promissory estoppel. This approach is consistent with that of certain other standard setters.

.25 Some respondents asked PSAB to consider whether there should be one standard covering all asset retirement obligations. This would include asset retirement obligations that could be assumed by the entity and those associated with landfill sites covered in Section PS 3270.

.26 PSAB concluded, and most respondents agreed, that the scope of the proposed standard should exclude the recognition of retirement obligations associated with tangible capital assets not controlled by the entity. This scope limitation is closely linked to the accounting treatment of capitalizing asset retirement costs on the grounds that these costs together with the cost of the related tangible capital asset provide a future economic benefit. Asset retirement costs on their own do not. Therefore, if a public sector entity assumes a retirement obligation relating to an asset of others, it is a liability but not an asset retirement obligation for the purposes of this proposed standard.

.27 PSAB also considered whether there are any compelling reasons why asset retirement obligations associated with landfill sites should be subject to a different standard and to a different accounting treatment. Both deal with legal obligations associated with the retirement of tangible capital assets controlled by the public sector entity. It appears that the difference in the accounting treatment between Section PS 3270 and the proposed standard is mainly dictated by the timing of when these standards were developed and the alternatives for accounting available at that time.[1] Further, the majority of other standard setters reviewed provide one standard on all asset retirement obligations including those associated with landfill sites.

.28 Given these arguments, PSAB concluded that closure and post-closure costs of a solid waste landfill should be subject to the same accounting treatment as other asset retirement obligations covered by this proposal. The Board believes this could be achieved by:

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[1] Tangible capital assets were not defined when Section PS 3270 was issued.

(a) including closure and post-closure costs within the scope of the proposed standard and withdrawing Section PS 3270; or

(b) modifying Section PS 3270 to align it with the proposed standard.

.29 PSAB is of the view that withdrawing Section PS 3270 and including closure and post-closure costs within the scope of the proposed standard would best address the public interest. Having two separate standards covering obligations of the same nature may add to confusion and result in redundancy.

.30 There are, however, some consequences of withdrawing Section PS 3270:

(a) Obligations would be recognized earlier as the accounting treatment would change from incremental recognition of liability based on usage to recognition on acquisition, construction, development or normal use. The earlier recognition of obligations would result in an earlier increase in net debt.

(b) The recognized cost of assets would increase because asset retirement costs associated with tangible capital assets in productive use would be added to its carrying amount rather than expensed.

(c) The costs associated with closed landfill sites would not be in scope of the proposed standard as it applies only to assets in productive use.

(d) More professional judgment may have to be used when applying the proposed standard as it applies to various types of asset retirement obligations rather than just to landfill sites.

(e) Some note disclosure would need to be modified to reflect the change in the accounting treatment.

.31 PSAB believes that application of consistent accounting principles to similar transactions is important and that the change in the accounting treatment is an expected outcome. However, in order to ensure that all critical issues have been considered, PSAB requested that local governments, stakeholders expected to be affected the most by the proposal to withdraw Section PS 3270, be consulted. This consultation has been conducted and the local government stakeholders' comments were considered in drafting the Exposure Draft. Specific examples have been added to illustrate the application of the proposed standard to costs associated with landfill sites. PSAB also updated disclosure requirements for requirements contained in Section PS 3270, where appropriate. However, more professional judgment may now have to be used as the proposed standard is principles based.

.32 The Statement of Principles applied only to asset retirement obligations associated with tangible capital assets in productive use. To accommodate costs associated with closed landfill sites, PSAB expanded the scope of its proposals to asset retirement obligations associated with assets no longer in productive use. This improvement also addresses the comments of some respondents who prefer a standard with a broader scope of applicability.

.33 The broader scope of the proposed Section would affect the scope of LIABILITY FOR CONTAMINATED SITES, Section PS 3260. The proposed consequential amendment to paragraph PS 3260.06 effectively removes obligations associated with expected contamination related to an entity's tangible capital assets no longer in productive use from the scope.

.34 Given the change in scope, PSAB considered it important to ensure that the boundaries between this proposal and Section PS 3260 are clear. Both standards would cover certain obligations associated with assets in productive use and those that are no longer in productive use.

.35 Determining whether to apply the proposed standard or Section PS 3260 involves professional judgment. There are three main distinguishing factors:

(a) the cause for the retirement or remediation obligation;

(b) the type of obligation; and

(c) the extent of contamination.

.36 The proposed standard addresses an asset retirement obligation that results from acquisition, construction, development or normal use of the asset. These obligations are predictable, likely to occur or unavoidable. They exclude costs related to improper use of a tangible capital asset or those resulting from an unexpected event such as an unexpected contamination. Section PS 3260 on the other hand, includes such costs within its scope. Further, Section PS 3260 requires the existence of contamination in order to consider if a remediation obligation has been incurred. Asset retirement obligations are not necessarily associated with contamination.

.37 A further difference between these two standards is the type of obligation. The proposed standard limits the obligations to those that are legally enforceable and associated with tangible capital assets of the entity. Section PS 3260 includes both legal obligations and those voluntarily assumed by the entity.

.38 In addition, the existence of contamination that exceeds an environmental standard at the financial reporting date is a necessary condition for recognition of a liability under Section PS 3260. The proposed standard does not include such a requirement.

.39 To clarify the boundaries between the proposed standard and Section PS 3260, PSAB added a decision tree, explained the meaning of "normal use" and proposes consequential amendments to Section PS 3260.

.40 Respondents also asked PSAB to provide general guidance that would further clarify the types of asset retirement activities in the scope of the proposed standard, and questioned some that have been specifically excluded (for example, waste and by-products). The Exposure Draft defines asset retirement activities and provides additional guidance. As per the definition, asset retirement activities are limited to those that relate to retirement of a tangible capital asset. Costs related to obligations created by waste or by-products produced by a tangible capital asset are not within the scope of these proposals as such costs are not associated with the retirement of a tangible capital asset but rather with the cleanup of waste or by-products. For example, the use of a nuclear facility may result in radioactive waste requiring clean up. These costs are not associated with the retirement of a tangible capital asset but rather with the cleanup of waste or by-products.

.41 Similarly, activities necessary to prepare a tangible capital asset for an alternative use over and above the retirement requirements are not associated with the retirement of the asset and are not within the scope of this Section. For example, a public sector entity may turn a gravel pit into a park. Only those activities necessary to retire the gravel pit would be in scope of the proposed standard.

.42 One respondent also questioned the exclusion of costs related to improper use of a tangible capital asset. These costs have been excluded as they do not relate to either the cost of acquiring, constructing or developing, or normal use of the tangible capital assets. They are unexpected in nature. For example, a certain amount of contamination may be inherent in the normal operations of a power plant, but a catastrophic accident caused by non-compliance with the company’s safety procedures is not. Therefore, the obligation to clean up after a catastrophic accident is not within the scope of these proposals. This does not mean that a liability does not exist; it is just not covered within the scope.

.43 Respondents have provided a number of other suggestions aimed at clarifying the scope. PSAB considered all of them and amended the guidance where these suggestions improved the clarity of the proposed standard.

Component versus network level

.44 The Statement of Principles proposed that the asset retirement obligations be accounted for at the individual component level regardless of how the tangible capital asset is accounted for. This approach was thought to best reflect the annual costs of these obligations as “back loading” of costs to future periods could result. Although the majority of respondents agreed with this proposal, several believe this treatment may be difficult for entities to apply in practice when they do not componentize their assets. Respondents also believe this approach would lead to inconsistency in accounting between the underlying asset and the retirement obligation associated with it. A choice of allocating the asset retirement costs either at the network or the component level was suggested by respondents.

.45 PSAB considers amortizing the retirement obligations over the useful life of the component rather than the network is more conceptually sound and produces better cost information. However, the Board agrees that this approach may lead to practical issues and a lack of consistency with TANGIBLE CAPITAL ASSETS, Section PS 3150, where paragraph PS 3150.12 allows a choice in accounting for tangible capital assets on a network or component basis. The Board is of the view that the allocation policy should be determined by the usefulness of the resulting information to the public sector entity and the cost versus the benefit of collecting and maintaining it. Consequently, the guidance was amended to allow a choice in allocating the retirement costs either at the network or the component level. The allocation of asset retirement costs at the network or the component level shall be consistent with that used for the related tangible capital asset.

Recoveries

.46 The Statement of Principles proposed that where a liability for an asset retirement obligation may be mitigated by a claim against a third party, the amount of the recovery is a separate asset, not an offset to the measurement of the liability. The majority of respondents agreed with this proposal. Others believe recoveries should be taken into consideration when determining the best estimate of the net expenditures required to complete the retirement. More than half of the respondents noted that the proposal is inconsistent with the guidance in Sections PS 3260 and CONTINGENT LIABILITIES, Section PS 3300, which state that a recovery is part of the measurement of liability and should be taken into account in measuring the amount.

.47 The Board agrees that the treatment of recoveries should be consistent with the principles in the PSA Handbook. Accordingly, ASSETS, Section PS 3210, or CONTINGENT ASSETS, Section PS 3320, would be followed.

.48 CONTINGENT LIABILITIES, Section PS 3300, allows for netting of the recovery against the related liability if the probability of recovery is likely. It provides general guidance on contingent liabilities, which includes situations where the recovery and the related liability are subject to the same risks. In those situations, it may be appropriate to consider the recovery as part of the measurement of the related liability. However, in the case of asset retirement obligations, typically two different counterparties are involved and there is no legal right of offset. Further, separate risks are associated with each the obligation and the recovery. Given this, recoveries associated with asset retirement obligations should not be netted against the liability. The same logic applies to recoveries associated with liabilities for remediation of contaminated sites. PSAB is proposing a consequential amendment to LIABILITY FOR CONTAMINATED SITES, Section PS 3260, to address this matter.

Measurement

.49 Most respondents agreed that the technique to be used in measuring a liability for an asset retirement obligation should not be explicitly specified in the standard. They recognized that a present value technique is often the best available method to measure a liability for an asset retirement obligation but may not be in all circumstances. Some respondents indicated that PSAB should outline different valuation techniques commonly expected to be used by entities measuring an asset retirement obligation and the nature of the circumstances that would be best suited to those different valuation techniques. Respondents also encouraged PSAB to provide factors useful in determining the appropriate discount rate.

.50 PSAB reconsidered its previous decisions of not providing prescriptive measurement guidance and continues to support the flexibility it provides. PSAB also upheld its previous conclusion of not being prescriptive on how to determine the appropriate discount rate as this may depend on a number of entity-specific factors and the present value methodology used. The PSA Handbook may benefit from general guidance on measurement techniques and related inputs; however, the proposed standard is not the best place for such guidance.

.51 One respondent had some reservations as to the merits of continuously updating the discount rates and the resulting potential volatility. Another respondent noted that the proposal does not explain why it is appropriate to capitalize the annual changes in the liability due to movements in the discount rate.

.52 As liability for an asset retirement obligation is generally long-term in nature, the measurement of the amount is likely to change as new information becomes available. Although it may result in potential volatility, reflecting these changes is an essential step in providing the best estimate of the measure of liability. Further, as asset retirement costs on their initial recording are capitalized, changes in the liability due to either the timing, the amount of the original estimate of undiscounted cash flows or the discount rate would be accounted for similarly. However, once the related tangible capital asset is retired, all subsequent changes in the estimate of the liability should be expensed.

Disclosure

.53 Respondents were supportive of the proposed disclosure requirements. The main issue identified was with respect to requirements in Principle 8(d), which requires disclosure of a reconciliation of the beginning and ending aggregated carrying amount of the liability. Some respondents found this disclosure requirement too onerous. PSAB continues to support this disclosure requirement given that it provides useful information about changes in the liability balance between reporting periods.

.54 The disclosure guidance has been amended to reflect respondents' suggestions to:

(a) disclose recoveries; and

(b) clarify that the disclosure of reasons for not recognizing a liability (outlined in paragraph PS 3280.64(f) of the Exposure Draft) applies only to situations where the public sector entity may not be able to make a reasonable estimate of the measurement of the liability.

.55 PSAB also:

(a) clarified that cases where an entity may not be able to make a reasonable estimate of the measurement of the liability are extremely rare; and

(b) enhanced disclosure requirements to capture relevant disclosures from Section PS 3270, which would be withdrawn.

Transitional provisions

.56 One respondent mentioned that public sector entities may have to make considerable changes in their systems and processes to capture the required information associated with the proposed standard. In determining the transitional provisions, PSAB considered the complexity of the proposed standard and the additional complications associated with the withdrawal of Section PS 3270. To ease transition, the Board proposes an extended transition date and an additional transitional provision option.

.57 ACCOUNTING CHANGES, Section PS 2120, allows a choice between retroactive and prospective application when a change in an accounting policy is made to conform to new Public Sector Accounting Standards. To make the transition less onerous, PSAB proposes a choice between prospective, retroactive and a form of a modified retroactive application. Therefore, those entities that prefer the application of a uniform accounting policy from period to period may choose the modified retroactive application, which still requires the restatement of prior periods but not as if the accounting policy had always been applied.

Other matters

.58 Some respondents asked PSAB to enhance the proposed standard by including further useful examples applicable to all public sector entities or modifying those considered to be inappropriate. The Exposure Draft reflects these changes.