# PS 3280
# Asset Retirement Obligations
# A Practical Approach

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# ARO's - WHAT ARE THEY?

**ARO is a legal obligation associated with the retirement of a tangible capital asset. Can be legislated, contractual or created by promissory estoppel.**

Which tangible capital assets could be affected?

- Those controlled by the public sector
- Currently in productive use
- No longer in productive use
- Includes leased tangible capital assets

**Examples of what's in:**

- Removal of Asbestos
- Retirement of x-ray machines
- Boilers
- Leased site restoration
- Landfill closure / post-closure

**What's not in:**

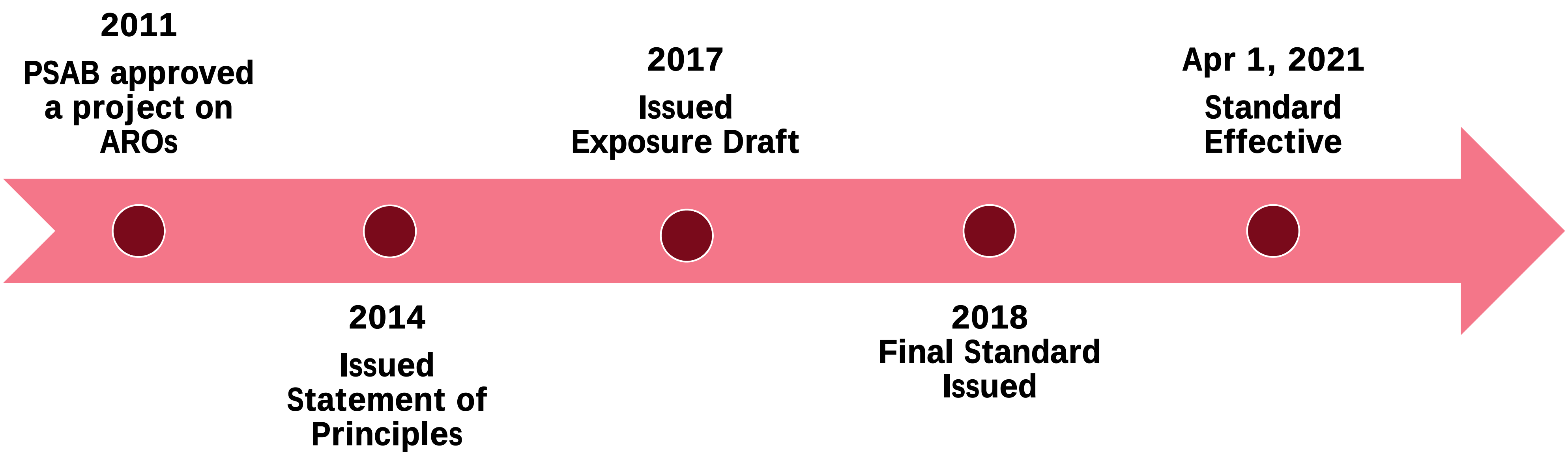
- Routine replacement/maintenance
- Improper use of TCA
- Remediation of contamination from unexpected event
- Waste/by-products
- Preparation for sale
- Selling costs

# WHAT DO WE CURRENTLY HAVE?

## Current standards:

- Contaminated sites: record liability for remediation costs when an asset (generally not in use) has contamination that exceeds a legislated standard; government will have to remediate
- Landfill obligations: record liability for closure and post-closure costs as capacity of landfill is utilized

# PS 3280 - ASSET RETIREMENT OBLIGATIONS



# WHAT'S COMING?

New Standard (April 1, 2021):

- Asset retirement obligations: record a liability for costs required to decommission an asset at its end of life ***or term of use***

Removal of landfill obligations standard

- New standard scopes in landfill closure/post closure

# HOW DO THEY COMPARE?

Similarity between the standards:

- All these obligations/payments will occur in the future so discounting is recommended
  - Discount rate to use is not expressly stated
- Best estimates of future costs, regularly re-evaluated
- Engineers or other experts likely needed for estimates

# SO WHAT'S THE DIFFERENCE?

Differences between the standards:

- ARO – Record FV of liability when future obligation arises (add amount to cost of TCA); accrete liability to future value over time (DR. to expense).
- Landfill – Record liability as the "asset is consumed". Deals with liability side only (which means immediate expense instead of amortization).
- Contaminated Sites – More limited in scope and recognition criteria.

Landfill standard to disappear – scoped into ARO

# HOW DO THESE COMPARE TO OTHER FRAMEWORKS?

ARO is the only section with a direct match in other standards

- ASPE 3110 very similar to PS 3280
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets
  - Very similar to ASPE and therefore to PSAS
  - Small differences such as IFRS referring to obligations as being either legal or constructive whereas ASPE legal, equitable or constructive

# OKAY, SO WHAT DO I NEED TO KNOW?

- An asset retirement obligation is a **legal** obligation associated with the retirement of a tangible capital asset.

- Asset retirement costs associated with a tangible capital asset **controlled** by the entity **increase the carrying amount** of the related tangible capital asset (or a component thereof) and are expensed in a rational and systematic manner.

- Asset retirement costs associated with an asset no longer in productive use are **expensed**.

## OKAY, SO WHAT DO I NEED TO KNOW?

- Subsequent measurement of the liability can result in **either** a **change in the carrying amount** of the related tangible capital asset (or a component thereof), or **an expense**, depending on the nature of the re-measurement and whether the asset remains in productive use.

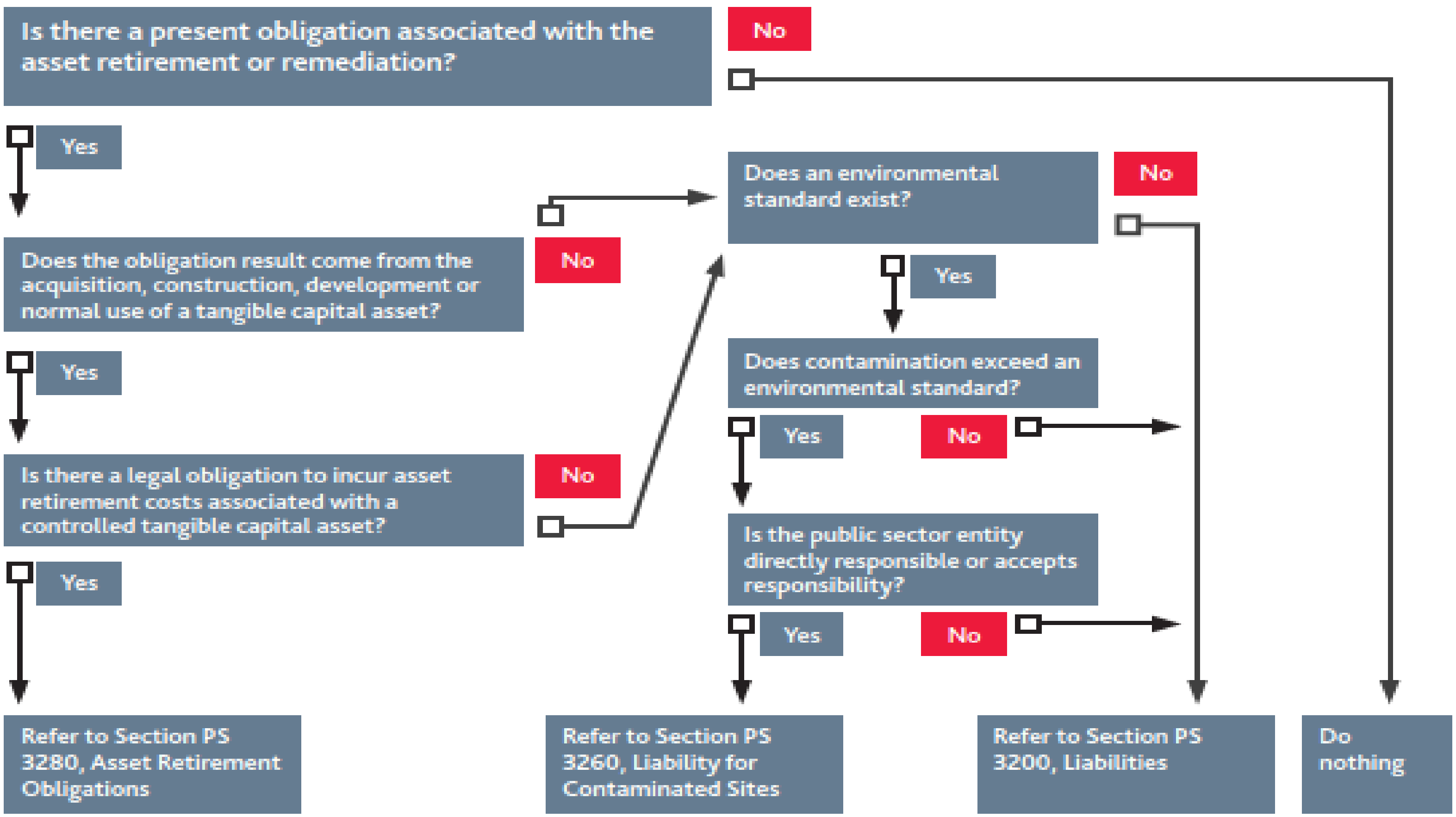
- Asset retirement obligations **include** post-retirement operation, maintenance and monitoring.

- A **present value technique** is often the best method with which to estimate the liability

# ARO vs. CONTAMINATED SITES

| | PS 3280 ARO Standard | Existing Section PS 3260 |
|---|---|---|
| **Cause for the retirement or remediation obligation** | -Acquisition, construction, development, normal use<br>-Not necessarily associated with contamination | - Unexpected event, improper use, contamination over time<br>- Contamination must exist |
| **Type of obligation** | Legal – related to TCA controlled by the entity | All liabilities - direct responsibility & assumed responsibility |
| **Extent of contamination** | Does not need to exceed the environmental standard | Must exceed the environmental standard |
| **Accounting for expected costs (including expected contamination)** | Capitalize as part of the cost of the TCA | Expense |

# ARO vs. CONTAMINATED SITES – A DECISION TREE



## BOTTOM LINE:

# A liability is a liability

**Liabilities** are present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits. (PS1000.44)

# PS1000.44 APPLIED TO ARO's:

A liability for an ARO is recognized when all of the following criteria are satisfied:

- There is a legal obligation to incur retirement costs in relation to a tangible capital asset;
- The past transaction or event giving rise to the liability has occurred (eg. Acquisition, construction, use of the asset);
- It is expected that future economic benefits will be given up; and
- A reasonable estimate of the amount can be made

# RECOGNITION AND ALLOCATION OF COSTS:

| ARO associated with: | Treatment of Costs |
|---|---|
| TCA<br>-in productive use<br>-not fully amortized | Capitalize asset retirement costs (add to cost of asset) & expense in rational and systematic manner (e.g. over useful life of asset) |
| TCA<br>-in productive use<br>-fully amortized | Capitalize asset retirement costs (add to cost of asset) & expense over revised estimate of remaining useful life |
| TCA<br>-not recognized | Expense asset retirement costs immediately |
| TCA<br>-no longer in productive use | Expense asset retirement costs immediately |

# Soooo . . . WHAT DO I RECORD?

- **<u>INITIALLY:</u>**
- **The estimate of a liability should include costs directly attributable to asset retirement activities, including:**
  - **Post-retirement operations, maintenance and monitoring that are an integral part of the retirement of the tangible capital asset; and**
  - **Costs of tangible capital assets acquired as part of asset retirement activities to the extent those assets have no alternative use**
- **Based on information available at the financial statement date**
- **Best estimate of the amount required to retire a tangible capital asset**
- **No prescriptive guidance on appropriate measurement techniques and discount rate included in the proposed standard**
- **A present value technique is often the best available method**

# WHAT ABOUT WHEN THE ESTIMATE CHANGES?

- Recognition of period-to-period changes in a liability:

| Resulting from: | TCA still in productive use - recognize: | TCA not in productive use - recognize: |
|---|---|---|
| Revisions to either:<br>-Timing;<br>-Amount of original estimate of undiscounted cash flows; or<br>-Discount Rate | By adding to cost of the related TCA & amortizing in rational and systematic manner | As expense in period incurred |
| Passage of time | As an accretion expense | As an accretion expense |

- Liability continues to be recognized until it is settled or otherwise extinguished

# WHAT IF PART OF THE COST IS RECOVERABLE?

- **Recognize <u>when</u>:**
  - **a) the recovery can be appropriately measured;**
  - **b) a reasonable estimate of the amount can be made; and**
  - **c) it is expected that future economic benefits will be obtained.**

- **A recovery should NOT be netted against the liability.**

- **A contingent recovery should be *disclosed* in accordance with Section PS 3320, *Contingent Assets***

- **Consequential amendment to PS 3260 Liability for Contaminated Sites to prohibit netting of recovery against the liability**

# OKAY, SO WHAT'S THE PRACTICAL APPROACH?

1) **Identify items in scope.**
   - What does the government control and what future costs are required to retire the asset?
   - Know what legislation and agreements impact controlled assets.
   - The right team: Finance, Public Works, Engineering, Asset Management, Legal. External?

2) **Determine if recognition criteria met (PS 3280.09)**
   - All laws, regulations, lease obligations identified?
   - All past transaction or events identified?
   - Reasonable estimate possible? If not, why not?
   - *Uncertainty*?

3) **Determine an appropriate estimate**
   - Initial measurement: information available for fair value of total expected costs (likely using discounting). All costs included (eg. Need to acquire assets with no alternate use).
   - Consistent use of information across similar obligations? Appropriate use of experts?
   - Subsequent measurement: passage of time (accrete to final value); changes in timing, amount, discount rate (accounting depends on in use/not in use).

# Hey Brian, do you have an example?

# Yes indeed, I have an example:

**Scenario:**

A public sector entity purchases a building containing asbestos on April 1, 2X21. Significant assumptions are as follows:

- The remaining useful life of the building is 10 years
- The entity plans to demolish the building at the end of its useful life and the relevant legislation requires that asbestos be removed in a prescribed manner
- The estimated cost of this removal in 2X31 is $1M
- The appropriate discount rate to compute the present value is 3%
- The public sector entity amortizes the building over its useful life using a straight-line method
- As at March 31, 2X26 (5 years after purchase) the entity revised the estimated cost of removal to $1.2M and the discount rate to 4%

- Note: The journal entries and calculations on the following slides deal only with the asset retirement costs (i.e., exclude capitalization and amortization of the underlying tangible capital asset)

# EXAMPLE (cont'd)

Initial measurement of the ARO Liability

Present value of the ARO liability as at April 1, 2X21 $744,094

**Journal entries**

April 1, 2X21:

| | | |
|---|---|---|
| Dr. Tangible capital asset | 744,094 | |
| Cr. ARO liability | | 744,094 |

To record the initial ARO liability

# EXAMPLE (cont'd)

**Subsequent Measurement of the ARO Liability Reflecting Changes in the Estimated Cash Flows and the Discount Rate**

| | |
|---|---|
| Present value of the ARO liability at March 31, 2X26 – before revision | $862,609 |
| Present value of the ARO liability at March 31, 2X26 – after revision | $986,313 |
| Present value of the incremental liability at March 31, 2X26 | $123,704 |

March 31, 2X26:

| | | |
|---|---|---|
| Dr. Tangible capital asset | 123,704 | |
| Cr. ARO liability | | 123,704 |

To record the subsequent change in ARO liability

# EXAMPLE (cont'd)

**Interest Method of Allocation**

| Year | Liability balance April 1 | Accretion | Change in estimate | Liability balance Mar. 31 |
|---|---|---|---|---|
| 2X21-2X22 | $ 744,094 | $ 22,323 | $ — | $ 766,417 |
| 2X22-2X23 | 766,417 | 22,992 | — | 789,409 |
| 2X23-2X24 | 789,409 | 23,683 | — | 813,092 |
| 2X24-2X25 | 813,092 | 24,392 | — | 837,484 |
| 2X25-2X26 | 837,484 | 25,125 | 123,704 | 986,313 |
| 2X26-2X27 | 986,313 | 39,452 | — | 1,025,765 |
| 2X27-2X28 | 1,025,765 | 41,031 | — | 1,066,796 |
| 2X28-2X29 | 1,066,796 | 42,671 | — | 1,109,467 |
| 2X29-2X30 | 1,109,467 | 44,379 | — | 1,153,846 |
| 2X30-2X31 | 1,153,846 | 46,154 | — | 1,200,000 |

# EXAMPLE (cont'd)

**Schedule of Expenses**

| Year end | Accretion expense | Amortization expense | Total expense |
|---|---|---|---|
| 2X22 | $22,323 | $74,409 | $ 96,732 |
| 2X23 | 22,992 | 74,409 | 97,401 |
| 2X24 | 23,683 | 74,409 | 98,092 |
| 2X25 | 24,392 | 74,409 | 98,801 |
| 2X26 | 25,125 | 74,409 | 99,534 |
| 2X27 | 39,452 | 99,150 | 138,602 |
| 2X28 | 41,031 | 99,150 | 140,181 |
| 2X29 | 42,671 | 99,150 | 141,821 |
| 2X30 | 44,379 | 99,150 | 143,529 |
| 2X31 | 46,154 | 99,150 | 145,304 |

# EXAMPLE (cont’d)

March 31, 2X21-2X31:

| | | |
|---|---|---|
| Dr. Amortization expense | Per schedule | |
| Cr. Accumulated amortization | | Per schedule |

To record amortization on the asset retirement cost

| | | |
|---|---|---|
| Dr. Accretion expense | Per schedule | |
| Cr. ARO liability | | Per schedule |

To record accretion expense on the ARO liability

# EXAMPLE (cont'd)

March 31, 2X31:

| | | |
|---|---|---|
| Dr. ARO liability | 1,200,000 | |
| Cr. Cash | | 1,200,000 |

To record settlement of the ARO liability

# IMPLICATIONS TO EXISTING LANDFILL LIABILITY

| | PS 3280 ARO Standard | Existing Section PS 3270 |
|---|---|---|
| **Liability** | -Fixed costs recognized fixed portion as incurred = earlier recognition;<br>-Predictable expense | Recognized incrementally, but variably, as landfill used = later recognition |
| **Total Liability** | Generally the same | |
| **Assets** | Asset retirement costs capitalized | No impact |
| **Net debt** | Earlier increase | Increases as landfill consumed |
| **Total expenses** | Generally the same | |
| **Annual expenses** | Generally larger initial liability, then amortization of TCA + accretion based on discount rate | Based on changes in amounts and timing of estimated costs + "consumption" |

# IMPLICATIONS TO EXISTING LANDFILL LIABILITY

Statement of Financial Position—comparison

| As at March 31 2x23 | ARO standard | PS 3270 |
|---|---|---|
| **Financial assets** | | |
| Cash and cash equivalents | $ 600,000 | $ 600,000 |
| Taxes receivable | 165,000 | 165,000 |
| Portfolio investments | 495,000 | 495,000 |
| | 1,260,000 | 1,260,000 |
| **Liabilities** | | |
| Accounts payable | 300,000 | 300,000 |
| Long-term debt | 2,000,000 | 2,000,000 |
| Asset retirement obligation—landfill | 295,532 | 29,451 |
| | 2,595,532 | 2,329,451 |
| **Net financial debt** | (1,335,532) | (1,069,451) |
| | | |
| **Non-financial assets** | | |
| Tangible capital assets | 10,258,233 | 10,000,000 |
| Prepaid expenses | 15,000 | 15,000 |
| | 10,273,233 | 10,015,000 |
| | | |
| **Accumulated surplus (deficit)** | $8,937,701 | $8,945,549 |

# WHAT DISCOUNT RATE SHOULD I USE?

Like any discounted long-term item, the choice of discount rates can have a big impact.

For example with our previous example of $1,000,000 ARO 10 years out, liability of:

- At 3.5% = $700,000
- At 1.5% = $862,000
- At 7.0% = $508,000

# WHAT DISCOUNT RATE SHOULD I USE?

**The standard does not prescribe a specific discount rate to use:**

> .47 A key input into a present value technique, such as a discounted cash flow calculation, is the discount rate. A discount rate reflects the time value of money and the risks specific to the liability for asset retirement obligations, for which future cash flow estimates have not been adjusted. **The assumptions applied in the cash flows and the discount rate should be internally consistent.** For example, if the cash flows include the effect of inflation, then the discount rate also incorporates the same inflation assumptions.

# WHAT DISCOUNT RATE SHOULD I USE?

Likely makes sense to use a rate similar to long-term debt rates of similar term; that is, entity’s cost of borrowing.

# TRANSITIONAL PROVISIONS

**Transitional provision options:**

- Retroactive application with restatement (usual PS 2120)
- Prospective application (not previously recognized or requires adjustment).
- Modified retrospective application without restatement (unique for existing AROs recorded). Adjustment to opening surplus.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