PRICEWATERHOUSECOOPERS

Corporate Watch

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Exposure Draft on Changes in Decommissioning, Restoration and other Similar Liabilities - Does it affect you?

FRS 16 *Property, Plant and Equipment* requires that the cost of an item of property, plant and equipment include the costs of dismantling and removing the asset and restoring the site, to the extent that these costs are recognised as a provision under FRS 37 *Provisions, Contingent Liabilities and Contingent Assets.* Currently, neither FRS 16 nor FRS 37 specifically addresses the accounting for the effect of changes in such liabilities, which this draft interpretation attempts to address. The proposed accounting treatment is complex and potentially difficult to apply.

Many Singapore companies have lease terms that require them to restore the leased site to the original condition at the end of the lease term. Such costs can be significant, for example, leases with JTC for chemical plants. This article examines the current requirements, and the proposed changes.

The International Accounting Standard Board's International Financial Reporting Interpretations Committee (IFRIC) issued its second draft Interpretation - D2 *Changes in Decommissioning, Restoration and other Similar Liabilities* in September 2003. Locally, the Council on Corporate Disclosure and Governance (CCDG) issued the Singapore equivalent draft interpretation shortly after the issuance by IFRIC, in its bid to closely align Singapore FRS with International Financial Reporting Standards. Comment period on the exposure draft ended 3 November 2003.

The current requirements

Initial recognition

Currently, FRS 16 *Property, Plant and Equipment* requires that the cost of an item of property, plant and equipment include costs that are directly attributable to bringing the asset to working condition necessary for its intended use. Such costs include the costs of dismantling and removing an asset and restoring the site, to the extent that these costs are recognised as a provision under FRS 37 *Provisions, Contingent Liabilities and Contingent Assets.* The measurement of such a liability is the estimated expenditure required to settle the liability, discounted to present value where the effect of discounting is material.

For example, a Singapore company enters into a 30-year lease with JTC today. Under the terms of the lease, it is required to restore the leased site to the original condition at the end of the lease term. Hence under FRS 16 and FRS 37, the company recognises an estimated restoration liability as part of the cost of the building to be built on the leasehold land. The restoration liability could be projected based on today s market prices to the end of the lease term and then discounted back to today.

Subsequent measurement

Under FRS 16, the restoration cost would be depreciated over the life of the item of property, plant and equipment. Under FRS 37, the liability would also be increased over time to recognise the time value , if the effect of discounting is material. Such accretion is classified as borrowing cost .

In our previous example, the restoration cost on the JTC leased site would be depreciated over the period of the lease. The restoration liability would be increased during the period of the lease to recognise the borrowing costs.

How is the change in the estimated liability of decommissioning or restoration accounted for?

Currently, **neither** FRS 16 nor FRS 37 specifically addresses the accounting for the effect of changes in such liability

although under FRS 37, companies are required to assess the measurement of the provision at every balance sheet date.

Generally, companies would account for changes in the estimated decommissioning liabilities in the income statement in the period where the estimate is adjusted.

Proposed treatments under ED/ INT FRS

The draft interpretation addresses the issue on whether changes in such liability should be recognised as current period income (or expense) or added to (or deducted from) the related asset.

The measurement of the provision is affected by the estimated outflow of resources required to settle the obligation (for example, a change in technology may reduce estimated cash flows required to settle the obligation) and the discount rates.

Hence, the proposed treatment is dependent on whether the change is a result of:

(i) a revision of estimated outflows of resources required to settle the obligation;

(ii) revisions to the current market-assessed discount rate; or

(iii) unwinding of discount rate

The draft interpretation proposes that for revisions as a result of (i) and (ii), the change in liability relating to the depreciated portion of the asset would be reflected in current period income or expense while the change relating to the portion of the asset that would be depreciated in future periods would be capitalised.

To illustrate this, the exposure draft includes two examples:

Example 1 - revision of estimated cash flows

An entity has a nuclear plant and a related decommissioning liability. The nuclear power plant started operating on 1 January 2000. The plant has a useful year of 40 years. Its initial cost was 120,000; this included an amount of decommissioning costs of 10,000, which represented 217,200 in estimated cash flows payable in 40 years discounted at a rate of 8%.

At 1 January 2010, the plant is 10 years old. The carrying amount of the asset relating to the decommissioning liability is 7,500 (being 10,000 less accumulated depreciation of 2,500. In addition, because of unwinding of discounting over 10 years at 8% p.a., the decommissioning liability has grown from 10,000 to 21,500.

On 1 January 2010, the entity estimates that as a result of technological advancements, the net present value of the decommissioning liability has decreased by 4,000. Discount rate is ascertained as remaining unchanged at the same time.

The proposed adjustments are as follows:

(i) Decrease the liability at 1 January 2010 by 4,000, i.e., from 21,500 to 17,500.

(ii) Calculate the amount of decommissioning liability that would have been capitalised in the cost of asset as at 1 January 2000, using 17,500 discounted at 8% p.a. from 2010 to 2000. Hence, the amount of decommissioning costs that would have been capitalised would be 8,000, instead of 10,000. Therefore, the decommissioning costs included in the plant and the related accumulated depreciation would be reduced by 2,000 and 500 (2,000 x 10/40) respectively, a net of 1,500.

(iii) The difference of 2,500 (being the change in liability of 4,000 less the amount adjusted against the carrying amount of capitalised decommissioning cost of 1,500) is adjusted against income for the period.

Example 2 - revision of discount rate

The same facts as Example 1 except that discount rate decreased from 8% to 6% p.a..

The proposed adjustment is as follows:

(i) Calculate the decommissioning liability as at 1 January 2010. This would amount to 37,500, obtained by discounting 217,200 (i.e. no change in expected cashflow at 2040) at 6% p.a. over the remaining 30 years of the life of plant. Hence, the liability should be increased by 16,000 (37,500 less 21,500).

(ii) Calculate the amount of decommissioning liability that would have been capitalised on 1 January 2000, using 37,500 discounted at 8% p.a. over 10 years. This would amount to 17,500 and hence, the decommissioning costs and the related accumulated depreciation would be increased by 7,500 (17,500 less 10,000) and 1,875 (7,500 x 10/40) respectively, a net of 5,625.

(iii) The difference of 10,375 (being the change in liability of 16,000 less the amount adjusted against the carrying amount of capitalised decommissioning cost of 5,625) is adjusted against income for the period.

IFRS News - November 2003 is now available

This issue features **measuring assets at deemed cost for first-time adoption of IFRS** and **accounting for fuel purchase contracts** by companies in the energy sector and their **exemption from IAS 39** *Financial Instruments: Recognition and Measurement*. This issue also contains the 3rd in the series of supplements on **ED 5, *Insurance Contracts - Phase 1***, looking at the proposals for recognition and measurement, and assesses the impact of these improvements on insurers.

From December 2003, IFRS News will begin a series of feature articles to clarify the requirements of IAS 39.

IFRS News is a monthly newsletter produced by PwC Global Corporate Reporting Group and is available for free download at the PwC Global website.

The **exceptions** to the above are where:

(i) the allocation would result in carrying amount of an asset becoming negative; or

(ii) the related asset has reached the end of its useful life.

In these cases, all changes in the liability shall be recognised as income or expense.

For revisions of liabilities resulting from unwinding of the discount rate, the change in liability shall be recognised in the income statement in the period it occurs.

Transitional provisions

Retrospective adjustments on the adoption of the interpretation is required. Adjustment relating to the depreciated portion of the asset would be adjusted to opening retained earnings. The portion that would be depreciated in the future would be capitalised at the date of adoption of the interpretation.

Implications to companies

As seen from the above, the proposed accounting treatment is complex.

First, it requires management to be able to attribute the change in the liability to either a change in estimated cash flow or a change in discount rate. In practice, the change may be due to a combination of the two factors and accounting for this will be complicated. Significant cost and effort is required to ensure compliance to the Interpretation.

Is the proposed approach sensible?

Changes in such liabilities fall under the category of changes in accounting estimates which should be recognised prospectively by including it in the income statement in the period of the change, if the change affects that period only, or the period of the change and future periods, if the change affects both.

However, the proposed accounting treatment in the draft interpretation is a hybrid of a change in accounting estimate (ie prospectice adjustment) and a correction of an error (retrospective adjustment). In addition, the retrospective treatment proposed in the draft interpretation is inconsistent with the Exposure Draft of Revised IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* published in May 2002, which requires retrospective application with restatement of prior periods and eliminates the allowed alternative treatment (i.e. the retrospective application with a cumulative adjustment in net profit or loss for the current period).

PwC proposed treatments

PwC Global Corporate Reporting Group has responded to IFRIC on the draft interpretation. In its response, it proposes the following approach:

Changes in discount rates

Changes in discount rates are the result of an economic event of the current period and should be reflected as such in the income statement. Changes due to the passage of time (i.e. the unwinding of the discount rate) are recognised as an expense in the income statement, and hence, to be consistent with this treatment, changes in discount rates should follow the same accounting treatment.

Changes in estimated cash flows

The accounting treatment for changes in estimated cash flows needs to follow the guidance in IAS 8 for changes in estimates, i.e. it should be included in the income statement for the period of change (if the change affects that period only) or in the period of change and future periods if the change affects both.

Is the asset and liability linked for subsequent measurement purposes?

The initial recognition of the liability is based on the assumption that the asset and liability are linked. Key to determining the proper accounting treatment for a change in the estimated cash flows is whether the asset and the liability continue to be linked for subsequent measurement purposes. This is a key conceptual issue because of the different measurement models for the asset (i.e. historical cost less depreciation and impairment) and the liability (i.e. best estimate of the expenditure required to settle the present obligation using current discount rates, which approximates fair value). IASB should clarify whether the subsequent measurement of the decommissioning liability and the asset should be linked by way of an amendment to IAS 16 before the IFRIC issues its Interpretation.

Yes, it is linked

If the subsequent measurement of the asset and liability is to be linked, changes in estimated cash flows would follow the accounting for initial recognition (i.e. the cost of the asset would be adjusted at the date of the change in estimate) and the resulting impact would affect the period of change as well as future periods. Where the increase in the carrying amount of the asset exceeds the asset s recoverable amount, an impairment charge would have to be recorded under IAS 36 *Impairment of Assets*.

No, it is not linked

If the subsequent measurement of the asset and liability is not to be linked, changes in the estimated cash flows would be treated as a remeasurement of the liability, and would be recognised in their entirety in the income statement in the period of change. ♠

For a copy of the entire exposure draft, please visit the CCDG website.

Reminder from RCB on Submissions through Bizfile

The Registrar of Companies and Businesses (RCB) noted that some companies had filed accounts containing missing or unclear pages electronically through Bizfile. In these cases, companies were requested to rectify the error by filing a "Notice of Error of Document Lodged" together with the complete/correct accounts. RCB requests that companies be more careful when making submissions through Bizfile. ♠

RCB's letter is available at the ICPAS website.

Singapore Board of Directors Survey 2002

This survey assesses the current Board practices especially in relation to the recommendations of the Singapore Code of Corporate Governance (Code), and to changes in Board practices since the second survey conducted in 2001.

This survey is the joint effort of Singapore Institute of Directors, Singapore Exchange Ltd, Egon Zehnder International, NUS Business School and PricewaterhouseCoopers. It is the third in a series of regular surveys on Board practices amongst listed companies in Singapore. The objective of this survey is to assess current Board practices especially in relation to the recommendations of the Singapore Code of Corporate Governance (Code), and to changes in Board practices since the second survey conducted in 2001.

The survey of 120 chairmen of the Board of Singapore listed companies was conducted in the last quarter of 2002 and the survey results were released in May 2003. The major findings from the survey are summarised below.

Board practices that remained broadly similar between 2002 and 2001

The average Board size remains at 7 with the mix of executive directors (EDs) and non-executive directors (NEDs) remaining at approximately 1:3. The percentage of foreign directors on Boards remains at around 20%.

Changes in Board practices in response to the guidelines of the Code

As expected, companies have made changes in Board practices that align themselves with the guidelines of the Code. This can be seen from the following:

- A significant increase in the existence of Nominating Committees and Remuneration Committees in the companies surveyed.
- About 20% of companies carry out a formal appraisal of the Board s performance as compared to 10% the previous year.
- 81% of the companies surveyed have an internal audit function in place, as compared to 65% the previous year. Broadly half of this is provided on an outsourced basis.
- A slight increase in the number of companies paying additional fees to chairmen and members of committees to recognise their added responsibilities.
- A slight overall increase in the frequency of Board meetings.

While the Code calls for a separation of the roles of the chairman and chief executive officer (CEO), about two-thirds of Boards which responded still have an executive chairman or chairman-cum-CEO. In addition, despite the call for more director training, only 9% of NEDs received more than 4 hours of training in the year surveyed.

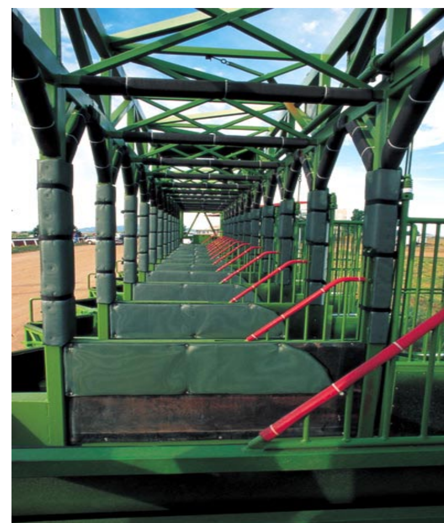
New findings on Board practices from the survey

- 50% of EDs do not sit on the Board of other listed companies, while 44% sit on 1 or 2 boards of other listed companies. In contrast, one-third of NEDs sit on 3 or more boards of other listed companies, whilst 3% of the 523 NEDs surveyed sit on more than 10 boards of other listed companies.
- Though 72% of the companies indicated that they present a risk report to the Board, only 39% of the companies surveyed have a formal risk identification and recording system and only 3% of companies have a Risk Management Committee.

Challenges to the implementation of the Code

The 2 most frequently cited challenges in implementing the Code are costs of compliance and performance appraisal of Board and directors. ♠

A copy of the full report is available upon request via email to catherine.tan@sg.pwc.com.



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