MFOA

Asset Retirement Obligations – Implementation Matters

September 19, 2019

Agenda

- ❑ **Introduction**
- ❑ **PS3280 – Asset retirement obligations (AROs) overview**
- ❑ **Overview of MFOA Guideline**
- ❑ **Project workplan and implementation**
- ❑ **Timeline and goals**
- ❑ **Case studies/examples**

Introductions

With you today

KPMG Speaker

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PS3280: Overview of Standard

Asset Retirement Obligations ("ARO") Overview

- What is an ARO?
- Scope exclusions
- Common retirement obligations
- Recognition and allocation
- ARO measurement

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ARO Overview

What is an ARO?

- A formal standard (PS3280) on ARO’s was issued by PSAB in August 2018, covering:
  - Retirement obligations associated with tangible capital assets controlled by a public sector entity (assumption of responsibility not a requirement);
  - Legal obligations, including an obligation created by promissory estoppel;
  - Includes solid waste landfill closure and post-closure liability (has resulted in the proposed amendment to withdraw Section PS 3270);
  - Asset retirement obligations associated with tangible capital assets that are in productive use and those that are no longer in productive use;
  - Three transitional provision options: Prospective; Retroactive; Modified retroactive application.
- Effective date April 1, 2021. Earlier adoption is permitted.
- Webcast available from KPMG and CPA Canada.

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ARO Overview

PS3280 Exclusions

- The standard EXCLUDES:
  - Routine replacement;
  - Improper use;
  - Unexpected event;
  - Alternative use;
  - Waste and by-products;
  - Costs that arise solely from a plan to sell.

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ARO Overview

Common Retirement Obligations

- Buildings with asbestos.
- Nuclear power plant decommissioning.
- Storage tank removal.
- Removal of radiologically contaminated medical equipment (x-rays or MRI's).
- Wastewater or sewage treatment facilities.
- Reclamation, closure and post-closure obligations associated with mining activities.
- Closure and post-closure obligations associated with landfills.
- Reforestation of land subject to a timber lease.

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ARO Overview

ARO - Recognition

- A liability should be recognized when, as at the financial reporting date:
  - 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;
  - it is expected that future economic benefits will be given up; and
  - a reasonable estimate of the amount can be made.
- A liability for an asset retirement obligation cannot be recognized <u>unless all of the criteria above</u> are satisfied.

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ARO Overview

ARO - Recognition/ Allocation

Recognition and allocation guidelines:

- Capitalize asset retirement obligation and allocate the cost in a rational and systematic manner.
- Capitalize vs. expense:
  - Capitalize asset retirement obligations associated with fully amortized tangible capital assets.
  - Expense asset retirement obligations associated with unrecognized tangible capital assets.
  - Expense asset retirement obligations associated with tangible capital assets no longer in productive use.

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ARO Overview

ARO - Measurement

- The estimate of a liability should include costs directly attributable to asset retirement activities.
  - Directly attributable costs would include, but are not limited to: payroll and benefits; equipment and facilities; materials; legal and other professional fees; and overhead costs directly attributable to the asset retirement activity.
  - Costs include only those related to the nature and extent of the asset retirement obligation in accordance with the agreement, contract, legislation, or a legally enforceable obligation establishing the liability.
- Costs would include post-retirement operations, maintenance and monitoring that are an integral part of the retirement of the tangible capital asset.
- Includes costs of tangible capital assets acquired as part of asset retirement activities to the extent those assets have no alternative use.
- Recognize period to period changes in liability:
  - Due to timing, amount of original estimate, discount rate – capitalize
  - Due to passage of time – expense
  - If underlying asset is retired - expense

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Overview of MFOA Guideline

MFOA Guide

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MFOA Guide

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MFOA Guide

Next Steps

- ❑ Finalize Guideline document
- ❑ Share Guideline document with MFOA members
- ❑ Webinar to review material in depth
- ❑ Selection of 3-5 municipalities for in depth implementation case studies
- ❑ Webinar to present case studies to members

Implementation

Implementation

- ❑ First things first
  - ❑ Project team members
  - ❑ Steering committee?
- ❑ Implementation target date
- ❑ Engagement of governance bodies
- ❑ Integrating the audit perspective

PS3260 Project Plan

	KEY ELEMENTS
1.	Confirm Implementation Date
2.	Stakeholder Awareness
3.	Document Policies / Processes
4.	Inventory all TCA's/ Sites
5.	Identify applicable regulations or legal requirements
6.	Create Retirement Obligation Profiles
7.	Define Risk Assessment Approach
8.	Undertake Risk Assessment / Analysis
9.	Measure / Recognize the Liability
10.	Interim External Audit Review
11.	Amend / Finalize Policies / Processes
12.	Update Data for Implementation Date

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Project Team - Key Members

- ❑ Public Works / Engineering
- ❑ Planning & Economic Development (Property Officers and Asset Managers; Information Systems Planner - GIS)
- ❑ City Manager’s Office / Legal Services
- ❑ Corporate Services / Financial Services

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Budgeting and Accounting – A Growing Divide

- ARO accounting will result in retirement obligations being recorded on the Statement of Financial Position, offset by an asset for capitalized retirement costs.
- Annual impact on the Statement of Operations represents the amortization of the capitalized costs.
- Accounting and reporting impact does not correspond to funding requirements for retirement activities
- Costs for retirement activities will be funded at a future date, as incurred – not over the asset life like amortization charges
- Importance of a reconciliation to facilitate Ministry reporting, funding requests, and communications with governance bodies

Sample Plan

City of Paradise
Proposed Work Plan and Timeline - PS3280 Implementation

Project Kick-Off

Meeting between the KPMG team and the City project team to discuss project scope and logistics
Validate work plan and timelines for PS3280 implementation

Development of a PS3280 Policy

Prepare a template of a PS3280 policy for the City
In conjunction with City representatives, develop a definition for in-scope assets that is aligned with PS 3280
In conjunction with City representatives, develop a definition for productive and non-productive assets consistent with PS 3280
In conjunction with City representatives, document known sources of legal obligations (ie: regulations; contracts; legislation; promissory estoppel)

Identification of TCA/ Sites Inventory

Develop inventory of in-scope assets or sites based on existing TCA listings, and inventories used for PS3260 contaminated sites
Reconcile the City's listing of City-owned sites to GIS or MPAC data to validate consistency
Conduct a workshop with City management and key representatives to enhance project awareness, and identify potential retirement obligations
Conduct follow-up interviews with City representatives to discuss potential retirement obligations
Apply the definition of productive and non-productive assets to the City's inventory
For potential retirement obligations - Confirm risk based criteria with City representatives to group like assets
-Validate retirement obligations considered in scope or potentially in scope based on PS 3280 recognition criteria
-Decide on implementation date and prospective or retroactive application of PS3280
-Finalize policy for accounting and reporting of asset retirement obligations

Phase 2 - Measure

Objective - determine the financial statement impact, if any, for in-scope retirement obligations

Potentiall *Building XYZ*

-consider continued accuracy and validity of prior site assessments
- consider need for phase three environmental testing on the site
-evaluate other information required to inform obligation measurement
-document key assumptions or variables
- complete assessment of potential costs of retirement based on management's best estimate
- monitor progress of potential sale

Step 3 - Reporting

Objective -In conjunction with the year end reporting exercise, consider any updates required for new information on contamination or retirement obligations for in-scope sites leading up to the implementation date
-Roll information and estimates obtained for in-scope sites into the liability reported in the 2022 consolidated financial statements
-Draft note disclosure related to retirement obligations (including potential obligations) in the 2022 consolidated financial statements

Step 4 - Maintain

Objective -Perform yearly review of TCA's/ sites maintained on the inventory listing and assess any changes in sites considered in scope or out of scope for PS3280
-Update measurement for in-scope assets/ sites to reflect any changes in the nature/extent of retirement activities

PS3280: Implementation Considerations

PS3280 Implementation Considerations

- Three key audit questions
- Identifying assets in scope
- Assessing in scope sites
- Measurement

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PS3280 Implementation Considerations

Three Key Audit Challenges

1. **Completeness. Can you demonstrate to the auditor that you have recorded all asset retirement obligations required under PS3280?**
   - Focus is on a comprehensive, documented process
   - Engagement of various stakeholders outside of finance to ensure you have adequate and complete information
   - Review of contracts, agreements, and any applicable regulations or legislation
   - Importance of a complete inventory of assets, that reconciles back to listings for TCA and contaminated sites

2. **Accuracy. Has the retirement obligation been measured correctly?**
   - Are all directly related costs for the retirement reflected in the measurement?
   - Has an appropriate discount rate been applied to determine net present value?

3. **Valuation. Do the capitalized retirement costs represent a future economic benefit?**
   - Retirement obligation costs should only be capitalized for an in-use asset which was itself previously capitalized

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PS3280 Implementation Considerations

Identifying Assets in Scope

- **Review active and inactive tangible capital assets to identify those with retirement obligations. (Target Date – December 2019)**
- Consider:
  - Retirement
  - Legal obligations
  - Solid waste landfills
  - Contaminated sites
- Reconcile this inventory with the site inventory for contaminated sites
- Engage functions outside of Finance (particularly Public Works and Engineering)

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PS3280 Implementation Considerations

Assessing in Scope Sites

- **Evaluate the inventory of assets in scope against the proposed recognition criteria: (Target Date – Fall 2020)**

  - 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;
  - It is expected that future economic benefits will be given up; and
  - A reasonable estimate of the amount can be made.

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PS3280 Implementation Considerations

Measurement

- **For identified in-scope assets meeting the recognition criteria: (Target Date – Fall 2021)**

  - Develop a best estimate of the liability for an asset retirement obligation to retire the tangible capital asset;
  - Benchmarks for an appropriate discount rate when applying a present value technique;
  - Define those costs directly attributable to asset retirement activities;
  - Documentation critical to auditability.

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Estimation Techniques

Deep Dive: Implementation Challenges

Estimation Techniques

- **Retirement obligations measured based on information available at the reporting date, and management's best estimate**
  - No expectation or requirement to have complete, perfect information
  - *"The estimate of the liability would require professional judgment and could be supplemented by experience, third-party quotes and, in some cases, reports of independent experts"*
  - *"Professional judgment will be required in assessing the appropriate measurement technique …The appropriate measurement technique depends on such factors as the extent and complexity of the future costs, and time frame over which activities will occur."*
  - Consider estimation techniques and basis of measurement used by peer entities.
  - Consistency of key assumptions
  - Document key assumptions, and consider sensitivity of inputs/ variables

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Case Studies

Landfills: Case Study

- Construction of landfill begins January 1, 2022
- Completion by January 1, 2023
- Expected operation until December 31, 2032
- Discount rate of 3%, all cash flows occur at end of year

	December 31					
	2033	2034	2035	2036	2037	Total
Closure cost - cover and vegation	200,000					200,000
Closure cost - facilities and monitoring	500,000					500,000
Post closure	20,000	20,000	20,000	20,000	20,000	100,000
Total	**720,000**	**20,000**	**20,000**	**20,000**	**20,000**	**800,000**
Present Value (December 31, 2023)	**535,748**	**14,448**	**14,028**	**13,619**	**13,222**	**591,065**

- PV of future cash outflows at end of 2023 = $591,065
- PV of future cash outflows at Jan. 1 2023 = $573,850

Landfills: Case Study

- December 31, 2023
  - Under PS3270 (Old standard):
    - Expense and liability = Usage/ Capacity x PV of expense – expenses recognized to date
    - Expense and liability = 10,000 tons/ 100,000 tons x $591,065 - $0 = $59,107
  - Under PS3280 ARO (New standard):
    - Liability recognized = PV of future outflows = $591,065
    - Tangible capital asset recognized at start of operation = PV of expenses = $573,850 (January 1, 2023)
    - Tangible capital asset at YE = Opening balance – amortization
    - Tangible capital asset at YE = $573,850 – $57,385 = $516,465
    - Total expense recognized = amortization + accretion of liability
    - Total expense recognized = $57,385 + ($591,065 – $573,850) = $74,600

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Landfills: Case Study

- December 31, 2024
  - Under PS3270 (Old standard):
    - Expense and liability = 20,000 tons/ 100,000 tons x $608,796 - $59,107 = $62,652
    - Total Liability = $121,759
  - Under PS3280 ARO (New standard):
    - Liability recognized = PV of future outflows = $608,796
    - Tangible capital asset at YE = Opening balance – amortization
    - Tangible capital asset at YE = = $516,465 – $57,385 = $459,080
    - Total expense recognized = amortization + accretion of liability
    - Total expense recognized = $57,385 + ($608,796 – $591,065) = $75,116

Asbestos: Case Study

- Public sector entity purchases a building containing asbestos for $15M on June 1, 2024
- Remaining useful life = 15 years
- Building will be demolished at the end of useful life
- Removal of asbestos is estimated to cost $1.5M
- Discount rate = 3%

- Value of Asset = PV of future outflow = $962,793
- Value of Liability = PV of future outflow = $962,793

*Note that the asset value would be capitalized as part of the cost base of the building and amortized over the life of the building

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Asbestos: Case Study

- Subsequent measurement:
  - Subsequent to the initial measurement, the entity would amortize the asset over the building's remaining useful life, while recognizing accretion expense to increase the value of the liability

- PV of future outflow = $977,128
- Amortization expense = $962,793/15 years/2 for half year = $32,093
- Accretion expense = change PV of future CF = $977,128 – 962,793 = $14,335

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Asbestos: Case Study

- At the end of 2035, the estimated cost to remove asbestos changed to $1.75M (from $1.5M) based on new information available
- The incremental cost should be accounted for from that point in time onwards

- At December 31, 2035:
  - Additional cost = $250,000
  - PV of additional Cost = $225,429

- Value of asset in 2035 = $224,652
- Revised value = $224,652 + $225,429 = $450,081
- Value of liability = $1,352,574
- Revised value = $1,352,574 + $225,429 = $1,578,003

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Other Items

- ❑ Underground pipes and infrastructure – routine replacement?
- ❑ Sewage treatment facilities - reference environmental assessment or closure plans
- ❑ Linear assets/ roads
- ❑ Contractual requirements for asset retirement

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Wrap-up & Questions

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