INTERIM GUIDANCE ON

ASSET

DECOMMISSIONING

OBLIGATIONS FOR 2013/14

**[EXPOSURE DRAFT:
SUBJECT TO EVIDENCE COLLATION]**

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LASAAC [The Local Authority (Scotland) Accounts Advisory Committee] is constituted of volunteer members representing the five funding bodies: CIPFA, ACCA, ICAS, Audit Scotland and the Scottish Government. LASAAC is primarily concerned with the development and promotion of proper accounting practice for Scottish local government. A key task in achieving this is LASAAC's representation on CIPFA-LASAAC which produces the UK-wide 'Code of Practice on Local Authority Accounting in the United Kingdom'.

Further information about LASAAC can be obtained at http://www.cipfascotland.org.uk/technical/lasaac.cfm

The Chartered Institute of Public Finance and Accountancy (CIPFA) provide secretariat support for LASAAC. If you would like to contact LASAAC please communicate with

Contact: Gareth Davies
Policy & Technical Officer
CIPFA in Scotland
Beaverbank Business Park
22 Logie Mill
Edinburgh
EH7 4HG
lasaac@cipfa.org.uk

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LASAAC Guidance on Asset Decommissioning Obligations: Background

1. This paper provides guidance for Scottish local government on accounting for asset decommissioning obligations. The guidance is considered relevant due to uncertainty in Scotland regarding the impact of compliance with the Code of Practice 2013/14[1] (Code 13/14) requirements on the Scottish legislative framework for borrowing powers.

2. This guidance does not seek to replace or replicate the requirements of the Code 13/14, IAS 16[2] (Property, Plant & Equipment) or IFRIC 1[3] (Changes in Existing Decommissioning, Restoration and Similar Liabilities). Reference to the accounting requirements contained in these reference sources will be required.

Interim Nature of Guidance

3. The local government accounting treatment of asset decommissioning obligations is a developing area in the United Kingdom. In particular CIPFA's Local Authority Accounting Panel plans to undertake a review of this area, in conjunction with stakeholders, which is expected to inform UK wide treatment during the 2014/15 financial year.

4. **LASAAC is concerned to ensure that any financial impact of this guidance is clearly identified. LASAAC intends providing worked examples to assist authorities in evaluating any impact on their finances. Authorities will be requested to quantify the effect of the guidance in order to inform further discussion on mechanisms to manage the impact.**

5. This guidance is therefore based on interpretation of the current requirements**. It is subject to amendment should UK wide practices be further specified or significant financial impact is identified.**

Assessment of Impact – Dialogue Between Authorities and External Auditors

6. In assessing the potential impact of the exposure draft it is recommended that authorities and external auditors engage in early discussions regarding critical judgements, the specific circumstances of the authority and the evidence utilised in assessing the impact of application.

Capital Expenditure

7. The Local Government in Scotland Act 2003[4] requires adherence to proper accounting practice. This includes, in order of priority, legislative requirements, legislative guidance and recognised local government accounting codes of practice. A key aspect of this is the proper identification of capital expenditure.

8. 'Asset decommissioning obligations' is not a term used in the Code 13/14. In this guidance the term is intended to refer to "the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located" (Code 13/14 para 4.1.2.22 bullet 3).

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[1] The "Code of Practice on Local Authority Accounting in the United Kingdom 2013/14" [CIPFA-LASAAC]
[2] IAS 16 is available free of charge upon registration at: http://www.ifrs.org/IFRSs/Pages/IAS.aspx
[3] IFRIC 1 is available free of charge upon registration at: http://www.ifrs.org/IFRSs/Pages/IAS.aspx

[4] Section 12 – see http://www.legislation.gov.uk/asp/2003/1

9. The guidance is regarded as applicable to all relevant asset decommissioning obligations. It is not specifically restricted to any one type of asset (e.g landfill sites) but, where such obligations arise, will also apply to other assets (e.g. quarries, wind turbines, waste treatment facilities, leased properties etc).

10. The guidance is intended to support implementation of the accounting requirements in the following aspects:

    1. Criteria for inclusion in the cost of an asset
    2. Pattern of decommissioning obligations
    3. Depreciation
    4. Valuation
    5. Unwinding of the discounted present value
    6. Componentisation
    7. Capital Financing Requirement
    8. Increases and Decreases in Asset Decommissioning Obligations (IFRIC 1)
    9. Requirement to Revalue All Assets in the Class (IFRIC 1)
    10. Timing of Recognition Point of Capital Expenditure
    11. Funding Impact of Recognition

Criteria for Inclusion in the Cost of an Asset

11. The Code 13/14 4.1.2.22 specifies that the cost of an asset includes ""the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located". This estimate is required to be treated as capital expenditure.

12. IAS 16 paragraph 18 states "The obligations for costs accounted for in accordance with IAS 2 or IAS 16 are recognised and measured in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.". Therefore decommissioning costs, such as dismantling and reinstatement, should only be recognised in an asset's costs when, at a minimum[5], the criteria for a provision are met. The criteria are stated in the Code 13/14 (8.2.2.12) and are summarised here as:

    - A present obligation exists as a result of a past event
    - An outflow of economic benefits or service potential is probable as settlement
    - A reliable estimate can be made

13. Reference to IAS 37[6] paragraph 19 is also recommended. Where the criteria are not met other disclosures (e.g. a contingent liability) may be required.

Pattern of Decommissioning Obligations

14. Where a provision is determined to be required a key initial task is to ascertain the pattern of the restoration or decommissioning obligations. In particular clarity is required as to:

    - The event(s) that actually trigger(s) the obligation for future restoration / decommissioning costs (e.g. the need for future cash flows to be incurred).
    - The estimated present value of the obligation for each trigger event.

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[5] This guidance assumes that a provision will be most commonly recognised, however where there is more certainty over the timing and amount of an obligation a creditor may be recognised. The accounting treatment is similar although: (a) a capital creditor should be regarded as an 'underlying liability' in the calculation of the Capital Financing Requirement, and (b) there will presumably be less volatility and movement in the recognised decommissioning obligations.

[6] IAS 37 is available free of charge upon registration at: http://www.ifrs.org/IFRSs/Pages/IAS.aspx, but this does not include the Appendices

15. IAS 37 (Provisions, Contingent Liabilities and Contingent Assets) Appendix C illustrates the necessity of this in relation to oil rig decommissioning costs. The example is summarised below

The example notes that 90% of the costs of decommissioning relate to removing the rig and restoring the site. The further 10% arises from damage caused by the extraction of the oil. At the balance sheet date the rig has been constructed but no oil has been extracted.

The example states that a provision should be made for the 90% of the costs because:

- A legal obligation exists (licence conditions, probable to arise)
- Obligating event is rig installation
- Costs incurred do not relate to future operations
- Obligation will result in outflow of economic benefits
- Difficult area is whether a reasonable estimate can be made (reasonable estimates are generally expected to be possible)

No provision is required for the 10% since no oil has been extracted. These costs will be accrued as the damage is caused.

16. In relation to assets such as landfill sites and quarries aspects for consideration may include:

    - The extent of restoration/ decommissioning costs incurred when the site is initially developed
    - The extent of further (additional) restoration costs that may arise as the site is utilised (e.g. in a 'multi-cell' site the restoration costs incurred when each new cell is 'opened')

17. The accounting requirements do not in themselves draw a distinction between reinstatement and aftercare costs. Instead the focus is generally on whether the development or use of the asset incurs an obligation that will have to be settled. This may include cost elements which are considered to be 'aftercare'.

18. It should be noted that some commentaries on IFRIC 1 draw attention to the uncertainties inherent in estimating future cash flows, especially in the longer term. Additionally the Code 13/14 (8.2.2.15) states "The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the reporting date." The potential for technological advancement, regulatory change, discount factor changes, or other factors to affect the expected costs, either increasing or decreasing the provision required, is highlighted.

19. There may therefore be a certain level of volatility in the provision required, and the potential for amendment of the asset historic cost at each year end.

Depreciation

20. Land is often exempted from depreciation as it is normally regarded as having an indefinite useful life. The Code 13/14 4.1.2.3.7 however notes that this exemption does not apply to "land subject to depletion, ie quarries and landfill sites".

21. It is however important that the residual value used to determine the depreciation charge should be based on the value of the asset assuming that the work represented by the provision has been undertaken. Failure to do so would effectively 'double charge' the CIES for the cost of the decommissioning work over the useful life of the landfill site (albeit a gain on disposal could be anticipated to arise if the asset is realised at the end of operations).

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22. The residual value should be stated as at the balance sheet date.

Valuation

23. Where classified as 'other land and buildings' assets should be carried at 'fair value' (Code 13/14 4.1.2.29) which is defined (4.1.2.9) as "the amount that would be paid for the asset in its existing use". This will normally be assessed according to RICS valuation standards. In some cases Depreciated Replacement Cost (DRC) may be used.

24. The IFRIC 1 'Illustrative Examples' (paragraph IE7) notes the following valuation points:

    - Any valuation should be the 'gross' value, not reduced for the extent of any provision or liability recognised on the balance sheet. Valuation on a 'net' basis (e.g. assuming that a buyer would adopt the liability to restore the site) would be incorrect as the liability is separately recorded on the balance sheet and this would result in the liability being double counted.

    - Equally if DRC is used to determine the valuation the estimate should include the costs of restoration covered by the provision since these are, within net assets, compensated for by the provision recognised on the balance sheet.

Unwinding of the Discounted Present Value

25. The Code 13/14 8.2.2.16 requires that, where the effect is material, the estimated costs are discounted to present value. The increase in the liability due to the passage of time is required to be recognised as an interest charge in the Surplus or Deficit on the Provision of Services.

26. This may be particularly relevant for landfill restoration or decommissioning costs where the cash flow settlement may be many years into the future.

27. Additionally annual changes in the appropriate discount rate could potentially add volatility to the estimated decommissioning obligation[7]. Consideration should be given as to the appropriate discount factor to be used, which could normally be expected to relate to the expected term of the provision or liability. Additionally the significance of any consequential change in the estimated liability should be assessed.

28. Only the present value equivalent of the decommissioning obligation would be open to capitalisation and, therefore, to financing as capital expenditure. Consequently the 'accrued interest' element of a relevant provision on the balance sheet will need to be excluded when determining the value capital funding or financing, such as a loans fund advance.

29. The imputed interest charge each year would be a charge to the General Fund since:

    - IFRIC 1 paragraph 8 specifies that capitalisation of this interest element is not permitted
    - There no known statutory basis for the reversal of the interest charge in the Movement in Reserves Statement

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[7] See IFRIC 1 para 3 (b) and para 4 - changes in the anticipated underlying cash flows or the discount rate may affect the estimated obligation and historic cost of the asset

Componentisation

30. Authorities may consider separate identification of any 'decommissioning' (e.g. restoration or reinstatement) element in their asset register. This would presumably assist in the application of potential changes in the estimate of decommissioning costs.

31. In doing so however it should be noted that the requirements of IFRIC 1 are considered to relate to the totality of the whole asset, not just the decommissioning element. This therefore requires that to apply IFRIC 1 the asset register balances, such as accumulated depreciation, for the whole (combined) asset would need to be used in determining the appropriate accounting treatment.

32. This need not necessarily preclude the componentisation of an asset (e.g. a landfill site with each 'cell' treated as a component) where decommissioning obligations can be specifically identified to each cell.

Capital Financing Requirement

33. The impact on Prudential Code indicators is not specifically addressed in the prudential Code[8] at present. The application of paragraph 93 of the Prudential Code (2011) may be subject to further specification following the CIPFA LAAP review referred to above (see paragraph 3 above). Paragraph 93 of the Prudential Code indicates that any 'underlying liability' should be excluded from the Capital Financing Requirement (CFR).

34. Subject to further specification LASAAC recommends that the capital expenditure element of a relevant provision is regarded as an 'underlying liability'. Therefore the CFR will increase, enabling a Loans Fund Advance to be made to support the asset cost increase.

35. This does not mean that authorities must borrow cash at the point the CFR increases. Instead the CFR reflects the underlying need to apply funding, at some point in time, to support the services provided by the asset. The funding impact of the Loans Fund Advance is considered further below.

Increases and Decreases in Asset Decommissioning Obligations (IFRIC 1)

36. The wording of IFRIC 1 paragraph 6 (a) (ii) may be open to different interpretations regarding increases in asset decommissioning obligations. For the avoidance of doubt LASAAC considers that, in applying paragraph 6 (a) (ii) it is appropriate for authorities to treat an increase in the liability as follows:

    - In the first instance to reduce the balance on the Revaluation Reserve to the extent of any credit balance existing for the asset, with this change reflected in Other Comprehensive Income & Expenditure

    - Where there is no remaining balance on the Revaluation Reserve the increase in the liability should be treated as per IFRIC 1 paragraph 5 (a) and 5 (c) i.e. treat the increase as capital expenditure and immediately undertake an impairment review.

37. A change in the discount rate used to calculate the present rate of the obligation may result in an increase or decrease in the asset decommissioning obligation[9].

EXPOSURE DRAFT - subject to evidence collation

[8] The Prudential Code for Capital Finance in Local Authorities (2011) CIPFA
[9] See IFRIC 1 paragraph 4

38. Increases which affect the historic cost of the asset should be reflected by increasing the associated Loans Fund Advance or utilising other funding sources.

39. LASAAC considers that decreases in the provision or liability that are credited to the CIES (SDPS)[10] should be reflected by crediting, through the Movement in Reserves Statement where appropriate, to the initial Loans Fund Advance or funding source.

Requirement to Revalue All Assets in the Class (IFRIC 1)

40. IFRIC 1 paragraph 6(c) states:

> "a change in the liability is an indication that the asset may have to be revalued"……"If a revaluation is necessary, all assets of that class shall be revalued."

41. LASAAC notes that a literal interpretation of this requirement could affect a wide variety of unrelated and dissimilar assets. LASAAC therefore considers that professional judgement should be applied in identifying those assets which are sufficiently similar in nature (or other factors affecting valuation) as to warrant simultaneous revaluation.

Timing of Recognition of Capital Expenditure

42. Expenditure may only be recognised as capital expenditure when the Code requirements for recognition as capital expenditure are met. This can include, for asset decommissioning obligations, reference to the date or trigger point at which the criteria for creating a provision are first met.

43. Dependent on the 'trigger point' for the creation of an obligation, the recognition point may be part way through the overall asset's expected useful life. This is not considered to prevent treatment of the capital costs represented by the obligation as capital expenditure. It should however be noted that this will exclude any interest element (i.e. the increase in present value of the obligation due to the passage of time) included in a provision or other liability on the balance sheet.

44. LASAAC considers that where asset decommissioning obligation recognition requires prior period restatement, the full asset decommissioning costs, excluding any interest element charged to the CIES (SDPS), should be treated as capital expenditure assuming the necessary criteria are met.

Funding Impact of Recognition

45. On recognition of an increase in capital expenditure due to the creation of a provision for asset decommissioning obligations statutory capital funding arrangements may be applied. This includes:

- Application of capital receipts
- Contribution From Current Revenue (CFCR)
- Loans Fund Advance

46. Where a Loans Fund Advance is utilised it is expected that the period for the repayment of the advance will be related, by default, to the remaining useful life of the overall asset (i.e. related to the future period of service provided by the asset). If the

[10] See IFRIC 1 "Changes in Existing Decommissioning, Restoration and Similar Liabilities" paragraph 6 (a) (i) where 'recognised in profit or loss' should for local government be interpreted as 'recognised in the Surplus or Deficit on the Provision of Services'.

EXPOSURE DRAFT - Subject to evidence collation

asset is near or at the end of its useful life and this places undue pressure on the financial management of an authority the Scottish Government may agree that a longer advance repayment period can be used. This will require the provision of quantified evidence to establish the scale of the issue (see further below).

47. As indicated (see paragraph **Error! Reference source not found.** above) any subsequent increases or decreases which affect the historic cost of the asset should be reflected by amendments to the balance of any associated Loans Fund Advance or original funding source.

48. It is anticipated that authorities will manage their cash position over the remaining life of the asset, or the period of the advance repayment, to ensure that cash is available to settle the asset decommissioning obligation. It is considered that authorities will have the capacity to achieve this cash management within the flexibilities of the existing regulatory framework. Based on this approach the settlement of the obligation at the end of the asset life will be a balance sheet movement (Dr Obligation Cr Cash) with no further funding charges to usable reserves at the point of settlement.

49. The anticipated capital expenditure funding and cash management approach is illustrated in a simplified example. The example is based on asset decommissioning costs of £100,000 with a loans fund advance repayable over 5 years on an equal instalments basis.

Yr	Loans Fund Advance	Statutory Repayment of Debt	General Fund Balance	Cash Retained /Invested	Cash Balance (Cumulative)
0	100	0	0	0	0
1	100	(20)	20	20	20
2	80	(20)	40	20	40
3	60	(20)	60	20	60
4	40	(20)	80	20	80
5	20	(20)	100	20	100
		(100)			**100**

Evidence Collation

50. LASAAC intends requesting evidence on the financial impact of this guidance.

51. Worked examples are proposed in order to assist authorities in quantifying and providing details of the financial impact of the guidance.

52. Authorities will be notified of the call for evidence as soon as possible. Further details are expected to be posted on-line at: http://www.cipfa.org/regions/scotland/policy-and-technical/local-authority-scotland-accounts-advisory-committee/guidance-and-publications

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