

# Defining Issues<sup>®</sup>

KPMG LLP (US)



## Alert

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## Interpretation Requires Recognition of Conditional Asset-Retirement Obligations

Companies must recognize a liability for the fair value of a legal obligation to perform asset-retirement activities that are conditional on a future event if the amount can be reasonably estimated, according to new FASB Interpretation 47.<sup>1</sup> The Interpretation provides guidance on whether the fair value is reasonably estimable, but it will nevertheless call for difficult determinations, in part because the uncertainty about the timing or method of settlement that is created by the condition must be considered in measuring the liability. Companies must adopt the Interpretation no later than the end of the fiscal year ending after December 15, 2005.

The premise underlying the Interpretation is a need for more uniform application of Statement 143.<sup>2</sup> Some companies have recognized conditional obligations when the asset is acquired or put in service, reflecting uncertainty about the timing and method of settlement in the estimate of fair value. Others have recognized conditional obligations when the asset is retired or when the company has specific plans to retire the asset.

The Interpretation clarifies that conditional obligations meet the definition of an asset-retirement obligation in Statement 143 and therefore should be recognized if their fair value is reasonably estimable. The Interpretation provides additional guidance to evaluate whether fair value is reasonably estimable. If it is not, Statement 143 requires that certain disclosures be made about the unrecognized asset-retirement obligations.

### Conditional Obligations

The Interpretation describes a conditional asset-retirement obligation as a legal obligation to perform an asset-retirement activity whose timing or method of settlement is conditional on a future event. The company may or may not be able to control the future event. Whether or not the company controls the future event, the obligation itself is unconditional. Only the timing or method of settlement is conditional.

<sup>1</sup> FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, March 2005, available at [www.fasb.org](http://www.fasb.org).

<sup>2</sup> FASB Statement No. 143, Accounting for Asset Retirement Obligations, June 2001, available at [www.fasb.org](http://www.fasb.org).

Statement 143 and Interpretation 47 treat uncertainties about obligations differently from Statement 5, under which uncertainties determine whether a liability should be recognized.<sup>3</sup> Statement 143 bases its liability-recognition criteria on “legal obligations.” Uncertainties about whether or when the company would be required to settle the obligation therefore do not determine whether an obligation should be recognized, but do affect the amount of the obligation. All legal asset-retirement obligations must be recognized under Statement 143 if their fair value can be reasonably estimated.

In keeping with Statement 143, Interpretation 47 maintains that a legal obligation to perform asset-retirement activities creates a liability even if its timing or the way it is settled depends on a future event. For example, a legal requirement to dispose of equipment in a factory in a specific way may be conditional on the company deciding to dismantle the factory. The company could decide to abandon the factory, deferring the obligation for the foreseeable future, but that would not relieve it of the obligation. The factory will eventually need to be dismantled and the equipment disposed of in the legally prescribed way, because the factory building will not last forever. The sale of the factory does not allow the selling company to avoid the obligation. The sale would transfer the obligation to another company, and for that reason affect the selling price, showing that the obligation existed before it was transferred and would continue to exist as the buyer’s obligation after the transfer.

Statement 143 requires the fair value of an asset-retirement obligation to be recognized *in the period it is incurred* if it can be reason-

ably estimated, with uncertainty about timing or method of settlement considered in the fair-value measurement. The obligating event indicating incurrence may be enactment of legal provisions or regulations, acquisition, construction, or use of assets subject to legal retirement obligations, or contractual or other agreements to perform asset-retirement activities.

#### “Reasonably Estimable”

The Interpretation provides guidance on when a company has sufficient information to reasonably estimate an asset-retirement obligation’s fair value. According to the Interpretation, information is sufficient if any of these three conditions is present: it is “evident” that the fair value of the obligation can be estimated from the acquisition price of the asset; there is an active market for the transfer of the obligation; or there is sufficient information to apply an expected-present-value technique.

An expected-present-value technique, as described in Concepts Statement 7, will most often be used to estimate fair value since the acquisition-price and active-market conditions frequently cannot be observed and measured.<sup>4</sup> A company applying an expected-present-value technique can generally make a reasonable estimate of fair value if it knows a range of potential settlement dates and has a basis for assigning probabilities to the potential settlement dates within that range. In so doing, uncertainty is incorporated in the measurement of the liability, not in its recognition. However, the Interpretation acknowledges that in some cases there may not be sufficient available information about the timing or method of settlement to reasonably estimate fair value.

The Interpretation says a company has sufficient information to apply an expected-present-

value-technique if either of the following conditions are present:

- The settlement date and method of settlement for the obligation are specified by the source of the legal obligation or other external parties. Uncertainty may exist about whether the external party will enforce the obligation, but the company still has an obligation to stand ready to perform the asset-retirement activities, and the uncertainty does not prevent the company from reasonably estimating the fair value of the obligation.
- The company has the information needed to estimate the settlement date or the range of potential settlement dates, the method of settlement or potential methods, and the probabilities associated with the potential settlement dates and potential settlement methods. Information that may help estimate the probabilities of potential settlement dates includes the company’s past practice, industry practice, management’s intent, and the asset’s estimated economic life.

The FASB expects that the narrower the range of potential settlement dates and the fewer potential settlement methods, the more likely the obligation’s fair value can be reasonably estimated. In estimating the future cash flows required to settle the obligation, the company would consider currently-available settlement methods.

#### Disclosure and Subsequent Accounting for Unrecognized Obligations

If the fair value of a legal obligation to perform asset-retirement activities is not reasonably estimable, the company should disclose that a liability exists but has not been recognized and the reasons why a reasonable estimate cannot be made. The liability should be

<sup>3</sup> FASB Statement No. 5, *Accounting for Contingencies*, March 1975, available at [www.fasb.org](http://www.fasb.org).

<sup>4</sup> FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, February 2000, available at [www.fasb.org](http://www.fasb.org).

recognized in the period in which sufficient information becomes available to reasonably estimate its fair value, with a corresponding increase in the carrying amount of the related asset. The additional asset-retirement cost would be depreciated over the remaining useful life of the asset.

### Applying the Interpretation

The first of the two following examples shows how a productive asset's normal operation can trigger a legal obligation that results in a liability for disposal procedures and how a liability can be created during a plant's ongoing operations for disposal activities that are legally required to be performed. The second example shows how a company's inability to reasonably estimate the fair value of a legal obligation to perform asset-retirement activities calls for disclosures and how the company responded to the requirement to recognize the liability when sufficient information became available to reasonably estimate the fair value of the obligation.

**Example 1:** A company owns and operates an oil refinery. Regulations require that contaminants in component parts be removed and disposed of as specified in the regulations when they are replaced and when the refinery is demolished, thus creating a legal obligation to perform asset-retirement activities. Because the company maintains the refinery and replaces component parts at regular intervals, it concludes that the timing of demolition is indeterminate. However, because the company replaces the component parts at regular intervals and the regulations require that the contaminants in the component parts be removed and disposed of in a specified way, the company should recognize a liability when the component parts become contaminated for the obligation to dispose of them upon their retirement.

**Example 2:** A company acquires a factory fireproofed with asbestos. Subsequently adopted regulations specify how the company is to dispose of the asbestos if the factory is demolished or undergoes major renovation. The company can in the future retire the factory as it sees fit, including by demolishing, selling, or abandoning it, but the legal obligation to perform asset-retirement activities is nevertheless incurred when the regulations are adopted, and should be recognized at that time, if fair value is reasonably estimable.

However, when the regulations are adopted, the company believes it has insufficient

information to estimate the fair value of the legal obligation to perform asset-retirement activities, because the settlement date or the range of potential settlement dates has not been specified by external parties and the company does not have the necessary information to estimate the settlement date or the range of potential settlement dates. The company should therefore disclose in its financial statements a description of the legal obligation to perform asset-retirement activities, the fact that no liability was recognized because fair value could not be reasonably estimated, and the reasons why fair value cannot be reasonably estimated.

### Applying Statement 143 to Obligations from an EU Directive

European subsidiaries affected by an EU directive on disposing of waste electrical and electronic equipment will have to account for any disposal obligations under Statement 143, according to a proposed FASB Staff Position with a comment deadline that ends April 21, 2005.\* The Directive requires EU-member countries to adopt legislation to regulate the collection, treatment, recovery, and environmentally sound disposal of electrical and electronic equipment. Equipment "put on the market" on or before August 13, 2005 is called "historical waste."

**Commercial Users.** The proposed Staff Position would require companies (commercial users) that own electrical and electronic equipment put on the market before August 13, 2005 to recognize a liability for the legal obligation to perform disposal activities when its EU-member country enacts legislation that creates the obligation. According to the Directive, the obligation remains with commercial users until the equipment is disposed of or, if allowed by its EU-member country, is replaced. When equipment is replaced, the obligation for its disposal could be transferred to the seller of the replacement equipment, if permitted by the EU-member country.

**Financing the Disposal of Equipment Held by Private Households.** The Directive requires that the disposal of private households' equipment put on the market before August 13, 2005 be financed by the producers and distributors who are "in the market" in a period specified by their respective EU-member country, which for the proposed Staff Position's purposes is the measurement period. Sellers will contribute to the costs to dispose of historical waste in amounts proportionate to their market share during the measurement period. No obligation would be recognized prior to the measurement period, because, according to the proposed Staff Position, the obligating event for sellers and distributors is their participation in the market during that period. The proposed Staff Position would require a seller or distributor to recognize a liability for the obligation over the measurement period as sales are made in the market. The liability would be adjusted for refinements in the estimate of market share and related costs.

\* Proposed FASB Staff Position No. FAS 143-a, Accounting for Electronic Equipment Waste Obligations, March 2005 available at [www.fasb.org](http://www.fasb.org). Directive 2002/96/EC of the European Parliament and of the Council of 27 January 2003 on Waste Electrical and Electronic Equipment, as amended by Directive 2003/108/EC of the European Parliament and of the Council of 8 December 2003.



Four years later, the company decides that it will in time abandon and demolish the factory because of decreasing demand for its products. The company is then aware of at least one method of settlement and can reasonably assign probabilities to potential settlement dates. It has the information needed to determine the fair value of the legal obligation using an expected-present-value technique. The company should therefore recognize a liability for the obligation in the period in which available information made it possible to reasonably estimate the fair value of the liability and should recognize a corresponding increase in the carrying amount of the factory for the asset-retirement cost.

#### Effective Date and Transition

The Interpretation must be adopted no later than the end of a company's fiscal year ending after December 15, 2005. Early adoption is encouraged. Restatement of interim financial information for the year of adoption is permitted, but is not required.

When the Interpretation is initially applied, the company should recognize the following amounts for conditional obligations not previously recognized:

- A liability for the reasonably estimable fair value of the legal obligation to perform asset-retirement activities that is conditional on a future event adjusted for cumulative accretion to the date of adoption,
- An asset-retirement cost capitalized as an increase to the carrying amount of the associated long-lived asset, and
- Accumulated depreciation on the capitalized cost.

Cumulative accretion and accumulated depreciation for the period should be measured *from* the date the liability and capitalized costs would have been recognized if the Interpretation were in effect when the company incurred the liability *to* the date the Interpretation was adopted. The difference should be reported as the cumulative effect of a change in accounting principle, as described in paragraph 20 of APB 20.<sup>5</sup> The amount reported as a cumulative-effect adjustment would also include the difference between any amounts recognized in the statement of financial position prior to the application of the Interpretation and the amount recognized when the Interpretation is adopted. The initial measurement of the obligation should reflect information, assumptions, and interest rates that are as of the date of adoption, not as of the earlier date when the legal obligation to perform asset-retirement activities was incurred.

The company should also present, on the face of the income statement, income before extraordinary items and net income with related per share amounts on a pro forma basis for all periods presented. The notes should include pro forma disclosure of the amount of the liability for the asset-retirement obligation at the beginning of the earliest year presented and at the end of each year presented as if the Interpretation had been applied during all periods. The pro forma amounts should be calculated using information, assumptions, and interest rates as of the date of adoption.

The descriptive and summary statements above are not intended to substitute for the text of FASB Interpretation 47 and proposed Staff Position FAS 143-a and are not necessarily applicable to any entity's specific circumstances. Companies accounting for legal obligations to perform asset-retirement activities that are conditional on a future event should rely on the text of the applicable documents that set out requirements and consult their accounting and legal advisors.

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Department of Professional  
Practice—Audit and Risk Advisory  
(212) 909-5600

#### Contributing authors:

Paul H. Munter  
John R. Lambert

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<sup>5</sup> APB Opinion No. 20, Accounting Changes, July 1971.