PHILIPPINE INTERPRETATIONS COMMITTEE (PIC)
QUESTIONS AND ANSWERS

Q&A No. 2019-08

Accounting for Asset Retirement or Restoration Obligation with the Adoption of PFRS 16, *Leases*

Background

In many cases, a lessee would enter into a lease agreement that requires the lessee to restore the leased asset back to its original condition (e.g., remove any leasehold improvements) at the end of the lease term. These are more commonly known as asset retirement or restoration obligations or asset decommissioning liabilities.

Under PAS 17, *Leases*, operating leases are not recognized on the balance sheet and accordingly, entities recognize the costs associated with asset retirement obligations (ARO) as a provision (i.e., a liability) in accordance with PAS 37, *Provisions, Contingent Liabilities and Contingent Assets* and the corresponding asset as an item of property, plant and equipment in accordance with paragraph 16(c) of PAS 16, *Property, Plant and Equipment*. However, upon adoption of PFRS 16, *Leases*, the accounting for such asset will change as PFRS 16.24(d) specifically indicate that the right-of-use asset (ROU) shall include, "an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories".

This accounting alert aims to provide guidance on how a lessee should account for an ARO upon adoption of PFRS 16, including how a lessee should, on transition, account for any existing ARO that was previously recognized as a provision and capitalized as part of property and equipment when the lessee was applying PAS 17.

Fact pattern 1:

On March 1, 2019, a lessee entered into a 10-year contract for the lease of a building. Under the terms of the contract, the lessee is required to remove any equipment installed and restore the building to its original condition at the end of lease term. Assume that applying PAS 37 requirements, the estimated cost of dismantling and restoration would be CU200,000.

Issue 1: Accounting for ARO at lease commencement date

How should the lessee account for the cost of dismantling the equipment and restoring the building to its original condition?

Consensus:

The cost of dismantling and restoration (i.e., the ARO) should be calculated and recognized as a provision in accordance with PAS 37, with a corresponding adjustment to the related ROU asset as required by PFRS 16.24(d). In this fact pattern, the lessee will add CU200,000 to the cost of the ROU asset on lease commencement date, which will then form part of the amount that will be amortized over the lease term.

Issue 2: Change in ARO after initial recognition

How should the lessee account for changes in the measurement of the ARO provision after initial recognition?

Consensus:

PAS 37.59 requires that provisions related to ARO be reviewed at the end of each reporting period or whenever there is a change in assumptions used (e.g., estimated cash outflows required to settle the ARO or timing of those cash flows) to reflect the current best estimate of the provision. Reference is then made to IFRIC 1, *Changes in Existing Decommissioning, Restoration and Similar Liabilities* for guidance in accounting for changes in the ARO provision.

IFRIC 1 applies to any decommissioning, restoration or similar liability that has been both recognized as part of the cost of an asset measured in accordance with PAS 16 or as part of the cost of a ROU asset in accordance with PFRS 16, and recognized as a liability in accordance with PAS 37. It addresses how the effect of the following events that change the measurement of an existing decommissioning, restoration or similar liability should be accounted for:

a. a change in the estimated outflow of resources embodying economic benefits (e.g., cash flows) required to settle the obligation;
b. a change in the current market-based discount rate (this includes changes in the time value of money and the risks specific to the liability); and
c. an increase that reflects the passage of time (also referred to as the unwinding of the discount).

IFRIC 1 requires that for a change related to (c) above, the periodic unwinding of the discount is recognized in profit or loss as a finance cost as it occurs. For a change caused by (a) or (b) above, the change in the liability should be added to or deducted from the cost of the asset (in this fact pattern, the ROU asset) to which it relates (assuming the asset is measured at cost*). The adjusted depreciable amount of the asset is then depreciated prospectively over its remaining term.

**IFRIC 1 also provides guidance if the asset is measured using the revaluation model.*

Fact pattern 2:

A lessee has a 10-year contract for the lease of a building, which has been accounted for as an operating lease under PAS 17. Under the terms of the contract, the lessee is required to remove any equipment installed and restore the building to its original condition at the end of lease term. On lease commencement date, the lessee recognized a provision relating to the equipment dismantling and restoration cost with a corresponding debit to property and equipment in accordance with PAS 16.16(c). On transition (to PFRS 16) date, the remaining lease term is 5 years.

Issue:

At transition date, how should the lessee account for any existing ARO recognized prior to adoption of PFRS 16?

Consensus:

Because ARO is not included as a component of lease liability, the measurement of such ARO is outside the scope of PFRS 16. Hence, its measurement is generally not affected by the transition to PFRS 16. Except in cases where the reassessment of lease-related assumptions (e.g., lease term) would affect the measurement of ARO-related provision, the amount of ARO existing at transition date would not be remeasured; rather, the balance of the ARO provision and any related asset will remain as previously measured. The asset will simply be reclassified from property and equipment to the related ROU asset as required under PFRS 16.24(d).

Assuming there is a change in lease-related assumptions that would impact the ARO measurement (e.g., change in lease term due to the new PFRS 16 requirements), the following will be the accounting treatment depending on the method used by the lessee in adopting PFRS 16:

a. Modified retrospective approach - Under this approach, the lessee uses the remaining lease term to discount back the amount of provision to transition date. Any adjustment is recognized as an adjustment to the ROU asset and ARO provision. This adjustment applies irrespective of which of the two methods in measuring the ROU asset will be chosen under the modified retrospective approach.

b. Full retrospective approach - The ARO provision and related asset, which gets adjusted to the ROU asset, should be remeasured from commencement of the lease, and then amortized over the revised or reassessed lease term. Because full retrospective approach is chosen, it is possible that the amount of cumulative adjustment to the ARO provision and the ROU asset at the beginning of the earliest period presented will not be the same; hence, it is possible that it might impact retained earnings.

Effective date

The effective date of the consensus in this Q&A follow that of Appendix C of PFRS 16, upon approval by the FRSC.

Date approved by PIC: <u>December 17, 2019</u>

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