

Complexities in Accounting for Unwinding of Discount under Ind AS 16 and AS 10



Appendix A of Ind AS 16 deals with the changes in the Existing De-commissioning, Restoration and other liabilities. Appendix A is an integral part of Ind AS 16. Ind AS 16 issued under the Companies Act, 2013 vide Companies (INDIAN Accounting Standards) Rules, 2015 duly amended by the Companies (INDIAN Accounting Standards) (Amendment) Rules, 2016 are applicable to a specified Class of Companies under the said Rules. AS-10 issued under the Companies Act, 1956 vide Companies (Accounting Standards) Rules, 2006 duly amended by the Companies (Accounting Standards) (Amendment) Rules, 2016 are applicable to rest of the Companies under the Companies Act, 2013 vide Companies (Indian Accounting Standards) Rules, 2015 and AS-10 of ICAI applicable to Non-Corporates deals with Property, Plant and Equipment, one of the most important items in the Balance sheet of business enterprises. However, one should note that the Companies (Accounting Standards) (Amendment) Rules, 2016 were issued u/s 642(1)(a), read with section 210A and Section 211(3C) of the Companies Act, 1956. However Section 642(1)(A) and Section 211(3C) were deleted and hence the Rules suffer from lack of proper legal authority. In fact, the Companies (Accounting Standards) Rules, 2006 should have been reissued under the Companies Act, 2013 and also all the subsequent amendments. Of course, all the above three different Accounting Standards stand harmonised as of today with practically no difference amongst them. Read on to know more...



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Changes in the Existing De-commissioning, Restoration and other liabilities

Changes in the Existing De-commissioning, Restoration and other liabilities could happen due to increase or decrease in estimated costs for dismantling or due to changes in the estimated timing of outflows, or in the discount rate applied to convert those future cash out flows in to P.V.

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One of the central principles of the Accounting Standards points out that no recognition of any amount can be made in the accounts unless it can be estimated reliably. When it is too difficult to estimate dismantling costs that may sometimes be incurred even after two decades or so, applying appropriate discount rate only compounds the problem of providing for the dismantling costs at P.V.

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In other words, any increase or decrease in the estimated dismantling costs, requires it to be adjusted against the Provision at P.V in the relevant year.

The Standard also requires that the Unwinding of discount as it occurs shall be debited as Finance Costs and the same cannot be capitalised as “Borrowing Costs.”

Unwinding of discount refers to adjustment to the Provision every year due to passage of time.

For Example, if an entity expects its Dismantling costs for a Plant at the end of 2 years is ₹100 and applies to it a Discount rate of 10%, it would provide ₹82.64 in the year “0”. [i.e $100 / (1.10 * 1.10) = ₹82.64$]. At the end of year 1, it would unwind the discount thereby providing an additional amount of Provision of ₹8.26, thus bringing the provision to ₹90.90 and at the end of 2nd year; it would further unwind the discount by making a further provision of ₹9.10. In other words at the end of year 2, when the dismantling costs are to be incurred, the Provision would stand at ₹100.

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Discount Rate

The discount rate is a pre-tax rate as tax effect is expected to generally offset in a broad sense both income by way of earning on the invested amount presently to meet future obligations and the expenditure when it is actually incurred.

For example, if we take the above example regarding unwinding of discount rate, we can see income of ₹8.26 in the first year and ₹9.10 in the second year by way of earnings on the invested amount of ₹82.64 in the year “0”, may be in the

interest bearing investments or even in the business itself and on the other hand we can see ₹100 charged off as dismantling costs in the end of second year for tax purposes which includes ₹8.26 and ₹9.10 as an addition to Provision in the first and second year.

So, on a broad basis the tax effect, generally, may not be material.

However, provision for Deferred Tax credit as per Ind AS–12 would offset the timing difference of tax benefit in respect of Depreciation charge of the capitalised amount of initial provision of ₹82.64 in the Year ‘0’ but also the Provision made for passage of time (i.e. unwinding of discount) charged as finance costs in the year 1 and 2 of ₹8.26 and ₹9.10.

The second question is whether the discount rate is a risk free rate or to be adjusted for risk premium.

Since the Ind AS 37- Provisions, Contingent Liabilities and Contingent Assets - refers to current market rates, each entity has to take its own decision on the discount rate based on its investment avenues. If the entity proposes to deploy the funds in risk free investments the discount rate would be Plain discount rate and in other cases, it would include appropriate risk premium based on the nature of investment.

For instance, if the entity proposes to invest the amount provided for dismantling costs in Government securities at an interest rate of 6%, the discount rate would be 6%. On the other hand, if it proposes to invest in its own business for which it’s estimated risk premium is 5%, it would use the discount rate of 11%. Of course the assessment of risk premium is a complex affair and more often a subjective and non-scientific decision.

Another issue is whether one should use discount rate adjusted for inflation/deflation. The Ind AS 37 is silent on this aspect. However, the future dismantling costs can be assessed based on current business conditions without adjusting for future inflation/deflation or alternatively can be adjusted for future inflation/deflation by using Index of consumer or whole sale prices or any other best indicator.

It is important to understand that the higher the discount rate used, the lower the current provision for dismantling costs and vice versa.

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For instance, let us take the above example regarding unwinding of discount rate and assume the dismantling cost of ₹100 after adjusting for average annual compounded inflation of 10 % would move to ₹121 at the end of year 2. [$₹100 + (₹100 * 10\% + ₹110 * 10\%)$]. In this case the discount rate of 10% should also be adjusted for the inflation, so that the Provision for Decommissioning charges in the year '0' reflects the right amount. Here, therefore the discount rate of 10% adjusted for the annual compounded inflation of 10% at the year I would be 11% and at the year II, it would stand at 12.1% [$10\% + (10\% * 10\% + 11\% * 10\%)$]. If we discount ₹121/ with the said discount rates of 11% and 12.1%, we arrive at ₹97.29, the amount to be provided at the year '0' [i.e. $(₹121 / (1 + .121)) = ₹108$ and $₹108 / (1 + .11) = ₹97.29$].

As we can observe the above Provision of ₹97/- is higher by ₹14/- when compared to ₹83/- as discussed earlier without inflation.

Due to inflation, the decommissioning charges at the Year 2 were pushed up to ₹121/- from ₹100/- an increase of ₹21 and when we discount it to P.V at the period '0', we get ₹17/- ($₹21 / 1.11 = ₹19$ and $₹19 / 1.10 = ₹17$). However, this increase of ₹17 was brought down to ₹14/- due to higher discount rate of 11% in the I year and 12.1% in the II year due to adjustment of inflation on the discount rate as discussed above.

Further, in the I yearend, Provision for unwinding of discount of ₹11 [i.e. $₹97 - (₹97 * 1.11)$] would be made, thereby taking the Provision to ₹108 ($₹97 + ₹11$). Again at the end of Year II, an amount of ₹13 [i.e.; $₹108 - (₹108 * 1.121)$] would be provided in respect of Unwinding the discount, thereby taking the Provision to ₹121.

Where dismantling costs are plain without adjustment for inflation, the discount rate should also be without adjusting for inflation.

For instance, let us again take the above example regarding unwinding of discount rate and assume the dismantling cost of ₹100 was without adjusting for inflation. In this case, there is no need to adjust the annual discount rate of 10 % for inflation. This is because, if there is an inflation of 10 % annually, the Dismantling costs would go up to ₹110 at the end of first year and to ₹121 at the end of second year.

However, due to inflation, the Investment value (assuming it is in inflation linked instruments/ securities etc.) also gets adjusted upwards. Further, due to inflation, the return on the investment amount would also rise by 10% in the 1st year from 10% to 11% and in the 2nd year from 11% to 12.1%.

The above is explained as under:

A. YEAR '0'

1. Amount Invested as per the Provision for Decommissioning:	₹82.64.
B. End of YEAR -1.	
1. Average Inflation Adjustment @ 10% on A-1 above	₹8.26
2. A 1 + B1	₹90.90
3. Average Inflation Adjusted Return @ 11 % P.A on A1	₹9.09
4. Total = B2+	₹99.99.
	Say ₹100

C. END OF YEAR -2

1. Average Inflation Adjustment @ 10% on B-2 above	₹09.09
2. B4 + C1	₹109.09
3. Inflation Adjusted Return @ 12.1 % P.A on B4	₹12.01
4. Total- C2 + C3	₹121.10 –
	Say ₹121

However, if an entity is of the view that the inflation in the above case would not result in neither adjustment in the invested amount nor bring inflation adjusted return, the only option is that it should discount the inflation adjusted Decommissioning costs of ₹121 above with the discount rate of 10 % unadjusted for inflation. In other words, it will provide for ₹100/- for decommissioning costs in the year '0'. [i.e.: $121 / (1.10)^2$].

Risk specific to Liability

Another important requirement under IND AS-37 as pointed out earlier is that the discount rate should also reflect risks specific to the liability.

In other words, if an entity in the above example estimates dismantling costs at ₹100/- at the end of year II with an inflation of 0% and further expects that it is unlikely that the liability would upswing due

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to lower competition amongst the Decommissioning Service Providers, or due to technological upgrades bringing in better quality in services related to decommissioning or due to increase in tax rates and so on. In such a scenario, the risk specific to liability is almost zero.

The ticklish question is the determination of discount rate after adjusting risk premium specific to liability. The second point is if the risk premium is added to the discount rate, naturally the Provision amount gets reduced instead of increase.

For example, in the instant case that we discussed above if the rate of 10 % is increased, say by 5 %, the discount rate adjusted for risk specific to liability would be 15 % and the P.V at the year '0' would be ₹75.61, of the decommissioning charges of ₹100/- at the end of II year, as against the P.V of ₹82.64 that we saw by using 10% discount rate. In other words, the amount of ₹75.61 invested @ 10% return would increase to ₹91.48 at the end of II year, though the Decommissioning charges to be incurred is ₹115/- at the end of II year.

Hence, adding the risk premium as done traditionally to rate is incorrect in the above situation and it appears to be right to deduct the same. In other words, the discount rate of 10 % duly adjusted for risk specific to liability would be 5 % (i.e. 10% - 5%). In the above situation, the P.V at the year '0' would be ₹90.70. [i.e. ₹100/(1.05)²].

If the same is invested at a return of 10 %, the amount would grow to ₹110 [₹ 90.70 * (1.10*1.10)]. But the required amount is ₹115/-. Hence we have to increase the risk premium in such a way that it would result in accumulating a sum of ₹115/- at the end of II year. This can be done by trial and error method.

In the above case, if we increase the risk premium to 7.5 % from 5 %, the discount rate would be 2.5 %, (i.e. 10 % - 7.5 %).

In the above situation, the P.V at the year '0' would be ₹95.18. [i.e. ₹100/(1.025)²].

If the same is invested at a return of 10 %, the amount would grow to ₹115 [₹95.18 * (1.10*1.10)] which is the required amount towards decommissioning charges at the end of II year.

However, the computations of working backwards by using discount rate adjusted for risk specific to liability appears to be absurd.

As per Ind AS 37, if the entity made adjustments in the future cash flows to reflect the future uncertainties, no adjustment shall be made in the discount rate towards risk specific to liability. Hence, it is sensible to adjust the cash flows of future to ₹115/- and use the discount rate of 10 % rather than the roundabout method of using the discount rate adjusted to risk specific to liability. If this is done, ₹115 discounted with 10 % would result in a sum of ₹95 [115/(1.10*1.10)], at the year '0' which matches with the P.V as arrived when we used the discount rate of 2.5 % duly adjusted for risk specific to liability.

We can also consider the following cases of adjusting the future cash flows to reflect the future uncertainties, without adjusting the discount rate for risk specific to liability.

Suppose there is 50 % probability that the liability of the entity at the end of II year would rise by ₹10, the entity should provide for the Decommissioning charges of ₹105/- [i.e. ₹100 + (₹10*50%)] and use the discount rate without adjustment for risk specific to liability.

In the above case, if any third party is prepared to commit at the period '0' to undertake the above decommissioning at ₹102/- at the end of year 2, the liability would be capped at ₹102/-.

Another instance may be that the liability is expected to go up anywhere between ₹101-119 at the end of year II. In this case, we use average and estimate the liability at ₹110/- (i.e. ₹101 + ₹119/2). In this case also, we should use the discount rate without adjusting for risk premium specific to liability.

Indeed, the Standard should have avoided suggesting such an option of adjusting the discount rate for risk specific to liability. Such an option left confusion in the minds of people whether the above risk comprises the credit risk of the entity itself.

The credit risk of entity would mean the uncertainty associated with the entity itself in meeting the decommissioning obligations at a future date. However, such a thought appears to be completely out of place. This is because if the entity is unable to meet its decommissioning obligations, enhancement of the Provision amount by considering the credit risk of the entity itself would serve no purpose unless such a Provision is specially encumbered to meet only decommissioning obligations. In any

case, securing decommissioning obligations to safeguard against the default by the entity itself is best achieved not by increasing the Provision but by other means of obtaining security from the entity like bank guarantee etc.

HELIX ENERGY SOLUTIONS Inc. Texas, USA

(Rigless Well intervention, robotics and Production facilities): The disclosures made by the above entity in respect of its accounts 2007 is interesting. It *inter alia* says that it accounts for Decommissioning liabilities in accordance with SFAS-143 (USGAAP). It capitalises the asset retirement costs as a part of the carrying cost of the asset at the time of purchase or construction of an asset. Such estimated costs include dismantling, removal, site reclamation and associated costs relating to the entity's oil and gas properties.

The company determines the asset retirement costs and discounts it to P.V using a Credit Adjusted Risk Free Discount Rate.

After the initial recording, the liability is increased for the passage of time. Subsequent adjustments in the cost estimate are reflected in the liability and the amounts continue to be amortised over the useful life of the related long-lived asset.

The company states that *"SFAS No. 143 calls for measurements of asset retirement obligations to include, as a component of expected costs, an estimate of the price that a third party would demand, and could expect to receive, for bearing the uncertainties and unforeseeable circumstances inherent in the obligations, sometimes referred to as a market-risk premium. To date, the oil and gas industry has no examples of credit-worthy third parties who are willing to assume this type of risk, for a determinable price, on major oil and gas production facilities and pipelines. Therefore, because determining such a market-risk premium would be an arbitrary process, we excluded it from our SFAS No. 143 estimates."* (source: www.wikinvest.com)

SUPERIOR ENERGY SERVICES, INC. AND SUBSIDIARIES (Oil Field services company, Houston, Texas, USA)

Regarding Decommissioning liabilities the company stated as under in its Annual accounts for the year 2011.

"The Company records estimated future decommissioning liabilities in accordance with the authoritative guidance related to asset retirement obligations (decommissioning liabilities), which requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred, with a corresponding increase in the carrying amount of the related long-lived asset. Subsequent to initial measurement, the decommissioning liability is required to be accreted each period to present value. The Company's decommissioning liabilities associated with the Bullwinkle platform and its related assets consist of costs related to the plugging of wells, the removal of the related facilities and equipment, and site restoration.

Whenever practical, the Company utilizes its own equipment and labour services to perform well abandonment and decommissioning work. When the Company performs these services, all recorded intercompany revenues and related costs of services are eliminated in the consolidated financial statements. The recorded decommissioning liability associated with a specific property is fully extinguished when the property is abandoned. The recorded liability is first reduced by all cash expenses incurred to abandon and decommission the property. If the recorded liability exceeds (or is less than) the Company's total costs, then the difference is reported as income (or loss) within revenue during the period in which the work is performed. The Company reviews the adequacy of its decommissioning liabilities whenever indicators suggest that the estimated cash flows needed to satisfy the liability have changed materially. The Company reviews its estimates for the timing of these expenditures on a quarterly basis.

In connection with the acquisition of Superior Completion Services in 2010, the Company assumed approximately \$10.0 million of decommissioning liabilities associated with restoring two chartered vessels to the original condition in which they were received."

(Source: United States Security and Exchange Commission Web site)

Indeed, there is no mention of discount rate adjustment specific to Liability for decommissioning. Another point to note is that even in the cases where such jobs are undertaken in-house, the provision for such liabilities are to be made. Further, the current Decommissioning liabilities should be reflected under Current Liabilities. ■