KPMG

Have you recorded all of your environmental and decommissioning obligations?

28 June 2021

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What's the issue?

Companies may cause environmental damage when installing an asset (e.g. an oil rig) and/or in their day-to-day operations (e.g. nuclear contamination). If they are required or committed to clean up, then they need to recognise this obligation in their financial statements.

As governments take action to combat climate change, new legislation or a company's public commitment on climate change could lead to new or changed provisions for environmental and decommissioning obligations.

Getting into more detail

What are the relevant requirements?

A company applies the general requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to recognise and measure a provision for an environmental or decommissioning obligation. A provision is recognised when:

- the company has a legal or a constructive obligation – e.g. to restore a site;
- the damage has already occurred;
- it is probable that an outflow of cash or other resources will be incurred; and
- the costs can be estimated reliably. *[IAS 37.14]*

A provision for damage caused by installing an asset is recognised as part of the cost of that asset and depreciated over its remaining useful life. A provision for damage caused by the company's operations is recognised in profit or loss as the related obligation arises.

What are the company's legal and constructive obligations?

In many cases, environmental and decommissioning obligations are triggered by law – i.e. they are legal obligations.

In addition, a constructive obligation may arise from published policies, past practices of remediating sites to a certain standard or public statements about clean-up policies – e.g. a company releases a press statement about its intention to clean up a site. A company needs to consider whether any public announcements on its climate-change commitments, including those disclosed elsewhere in the annual report, give rise to new constructive obligations. *[IAS 37.10]*

Although there may be changes in the law triggered by climate change – e.g. changes to the extent of remediation required – a company will recognise new obligations or changes in existing obligations only when it is virtually certain that the legislation will be enacted as it is drafted. *[IAS 37.22]*

Companies could see an increase in or new environmental and decommissioning obligations because of new legislation or their public commitment on climate change.

Provision is recognised only for damage that has occurred

A provision reflects only damage caused at the reporting date – it does not include expected future damage. *[IAS 37.19]*

For example, a company may incur an obligation when constructing an asset and also expect to incur additional obligations in the future as it operates the asset and emits pollutants. In this case, the company recognises the obligation relating to construction of the asset during its construction. It recognises the obligations relating to using the asset in future periods – i.e. as the pollutants are emitted. *[IAS 37.14, IE.C.Ex3]*

Cost of remediation

A provision is measured at the company's best estimate of the future clean-up costs. Making the estimate may require specialised knowledge of environmental issues – e.g. the quantity and type of contaminants involved, the local geography and remediation costs. Provisions can involve significant measurement uncertainty because of the complexities associated with remediation activities and the fact that work will often take place far in the future. *[IAS 37.36]*

In making its estimate, a company considers how potential future changes linked to climate change may impact the costs of remediation – e.g. using electric vehicles to undertake earthworks or using other low-emission technologies. A company may also need to consider how changes to expected climate conditions at a site may affect remediation plans – e.g. increased chance of extreme weather events or changes in average rainfall. However, a company includes changes relating to future events only when there is sufficient objective evidence that they will occur. *[IAS 37.36–37, 48–49]*

Timing of remediation work

Decommissioning and remediation of environmental damage will often take place far in the future.Therefore, the effects of discounting are normally material for decommissioning and environmental liabilities. A company needs to consider the expected useful life of the related asset when determining the expected timing of the outflow of cash or other resources. *[IAS 37.45]*

If climate-change impacts affect the expected useful life of certain assets, then a company may need to revise the expected timing of its remediation activities accordingly. For example, if it now expects certain sites to close earlier, then it may need to undertake remediation work earlier. Generally, the effect of any changes to an existing obligation is added to or deducted from the cost of the related asset and depreciated prospectively over the asset's remaining useful life. *[IFRIC 1.5]*

If the company is not required to decommission an asset immediately after it stops using the asset, then it uses its best estimate of the timing of the cash flows when measuring the obligation. *[IAS 37.36]*

Disclosures

Companies need to provide clear and meaningful disclosures about significant judgements and estimates made in recognising and measuring environmental and decommissioning provisions.

Actions for management to take now

- Consider whether there are any changes in legislation that may result in new obligations or changes to existing obligations.
- Review recent company announcements and assess whether they have created a constructive obligation.
- Assess whether the expected timing and amount of remediation costs need adjustment.

– Provide clear and meaningful disclosures about significant judgements and estimates made in recognising and measuring environmental and decommissioning provisions.

References to 'Insights' mean our publication **Insights into IFRS**

Publication name: *Have you recorded all of your environmental and decommissioning obligations?*

Publication date: June 2021