GUIDE TO ACCOUNTING FOR ASSET RETIREMENT OBLIGATIONS

An Analysis of FASB Statement No. 143
We gratefully acknowledge our technical team in the KPMG Department of Professional Practice as primary authors of this book. Landon Westerlund and Mark Bielstein led the efforts, with significant contributions from John Guinan, Carol Clarke, Carmen Bailey, Kimber Bascom, Melanie Dolan, Allen Kekish, and Rocky Duckworth.

Designed and produced by the NDPPS publications and project management group of KPMG LLP.
Manager and editor: Lee Dombrowski
Design: Nisha Lane
Layout: Arleen Formicola

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Overview

FASB Statement No. 143, Accounting for Asset Retirement Obligations (Statement 143), addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and for the associated asset retirement costs. The Statement was released in August 2001.

This guide provides a summary of major provisions of Statement 143 and examples of the application of those provisions. It also identifies and provides guidance on a number of implementation issues related to the application of the Statement.

The Financial Accounting Standards Board (FASB) began its project on asset retirement obligations in 1994 initially to address the accounting for the costs of nuclear decommissioning. The FASB subsequently expanded the scope of the project to include closure or removal-type costs in other industries. As a result, Statement 143 applies to all entities.

Statement 143 requires an enterprise to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that results from the acquisition, construction, development or normal use of the assets. The enterprise also should record a corresponding increase to the carrying amount of the related long-lived asset (i.e., the associated asset retirement costs) and depreciate that cost over the estimated remaining useful life of the asset. The liability is adjusted each period to reflect the passage of time (i.e., accretion expense) and changes in the estimated future cash flows underlying the initial fair value measurement. Because of the extensive use of estimates, many enterprises will record a gain or loss when they settle the obligation.

Key Provisions of Statement 143

Statement 143 requires enterprises in all industries to:

- Recognize a liability for all legal obligations associated with the retirement of tangible long-lived assets;
- Recognize the liability at fair value and capitalize an equal amount as a cost of the asset and depreciate it over the estimated remaining useful life of the asset;
- Increase the liability for the passage of time (accretion) and report the change as an operating expense (accretion expense);
- Adjust the liability for changes in the timing or the amount of the estimated undiscounted cash flows with a corresponding change to the carrying amount of the asset;
- Recognize a gain or loss on the settlement of the obligation, which generally occurs when the associated asset is retired; and
- Recognize a liability for all existing asset retirement obligations and the associated asset retirement costs at the date of adoption.
Statement 143 will conform the accounting methods for asset retirement obligations that exist in numerous industries (e.g., mining, oil and gas, and utility) and it will require all enterprises in all industries to recognize an obligation when the conditions in Statement 143 are met. Statement 143 also prohibits the recognition of liabilities for asset retirement activities when the conditions in Statement 143 are not met and, therefore, will change practice in many industries. For example, Statement 143 amends FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, to require that dismantlement, restoration, and abandonment costs related to oil and gas properties be accounted for in accordance with Statement 143, which will result in significant changes for oil and gas companies. Statement 143 also could result in increases in liabilities, assets, and expense recognition in financial statements. Therefore, adoption of Statement 143 may have implications on recorded obligations, debt covenant compliance, rating agency considerations, and market expectations.

Enterprises are required to adopt Statement 143 for fiscal years that begin after June 15, 2002.

**Key Terms of Statement 143**

Statement 143 includes a number of terms that must be understood in applying the new standard:

- **Asset Retirement Obligation**—an obligation associated with the retirement of a tangible long-lived asset. Statement 143 requires liability recognition for legal obligations associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, or the normal operation of those assets.

- **Retirement**—the other-than-temporary removal of a long-lived asset from service. Retirements may occur through sale, abandonment, recycling, or disposal. Temporary idling of an asset does not represent a retirement.

- **Asset Retirement Cost**—the amount capitalized that increases the carrying amount of the asset when the asset retirement obligation is initially recognized.

- **Legal Obligation**—an obligation that a party is required to settle as a result of an existing law, statute, ordinance, or written or oral contract, or by legal construction of a contract under the doctrine of promissory estoppel.
Scope of the Statement

Statement 143 applies to all entities that have legal obligations associated with the retirement of a tangible long-lived asset that result from the acquisition, construction, development or the normal use of the long-lived asset. The Statement requires an enterprise to recognize a liability for legal obligations associated with the retirement of a long-lived asset. As a result, the determination as to whether a legal obligation exists is an important issue in the application of the Statement.

Q1. Does Statement 143 apply only to future retirement activities when the enterprise is legally obligated to retire the asset?

A. No. Statement 143 is not limited to retirement activities related to assets that the enterprise is legally required to retire. Although the Statement applies to legal obligations to retire an asset, we believe that the Statement also applies to legal obligations related to the retirement of assets even when the enterprise is not legally required to retire an asset.

For example, Statement 143 applies to situations where an enterprise is legally required to retire an asset after a specified period of time and dispose of the asset in a certain manner. In addition, we believe that Statement 143 also applies to situations where an enterprise is not legally required to retire the asset at a specified time but is legally obligated to dispose of the asset in a certain manner when the asset is retired.

The example in paragraph A15 of Statement 143 demonstrates that the provisions of the Statement apply to situations where the enterprise is not legally required to retire an asset at a specific time. In that example, an enterprise replaces bricks that line a kiln in an aluminum smelter. Although the enterprise is not legally obligated to retire the bricks, it does replace the bricks periodically. However, when the bricks are removed, the enterprise is legally obligated to dispose of the bricks at a special hazardous waste site because they are contaminated with hazardous chemicals in the kiln. The obligation to dispose of the bricks in a specific manner is a legal asset retirement obligation within the scope of Statement 143. That obligation should be recognized when it is incurred—when the bricks become contaminated (i.e., during the operating life cycle of the bricks) and become subject to the disposal obligation.

However, we understand from discussions with the FASB staff that there may be differing views among the FASB staff on this issue and that the FASB staff is considering whether additional guidance should be provided.
SECTION 1: SCOPE OF THE STATEMENT

Legal Obligations

A legal obligation can result from a governmental action, an agreement between entities, or a promise conveyed to a third party (including the public) that imposes a reasonable expectation of performance under the doctrine of promissory estoppel. Black's Law Dictionary, seventh edition, defines promissory estoppel as "the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment." As a result of those requirements, enterprises will need to evaluate all relevant communications, for example, promises regarding asset retirements made in press releases and press conferences by company executives, to determine whether legal obligations for asset retirements have arisen under the doctrine of promissory estoppel. The determination of whether a legal obligation exists may not be clear in many cases, and likely will require active involvement by the enterprise’s legal advisors.

FASB Concepts Statement No. 6, Elements of Financial Statements, indicates that liabilities may arise from “constructive obligations” as well as legal obligations. However, since the determination of whether a “constructive obligation” exists is very subjective, the FASB concluded that liabilities recognized for asset retirement obligations should be legal obligations, including those resulting from the doctrine of promissory estoppel.

Q2. An enterprise operates a manufacturing plant that it plans to retire in five years. The original retirement plan was to abandon the site without demolishing the building. Due to negative publicity, the enterprise’s CEO announces at a press conference that the enterprise plans to demolish the building and restore the land to its original state. Does the promise made by the CEO create a legal obligation under the doctrine of promissory estoppel?

A. Although no law, statute, ordinance or written contract exists between the enterprise and the community, the promise made by the CEO may have created a legal obligation under the doctrine of promissory estoppel. The enterprise and its legal advisors should evaluate the situation to determine whether a legal obligation exists. (Refer to paragraphs A3 and A4 of the Statement.)

The determination of whether a legal obligation exists can be more complicated for an enterprise that operates in multiple locations and jurisdictions. The enterprise should evaluate the statutes, regulations and laws in each locality, state and foreign jurisdiction in which it owns or operates tangible long-lived assets to determine whether legal obligations exist to perform asset retirement activities.
Q3. An enterprise operates a manufacturing plant in a foreign country that it plans to retire in five years. The enterprise’s CEO announces at a press conference that the enterprise plans to demolish the building and restore the land to its original state. Does the promise made by the CEO create a legal obligation under the doctrine of promissory estoppel?

A. As indicated in the response to Question 2, the promise made by the CEO may have created a legal obligation under the doctrine of promissory estoppel. However, this question is complicated by the fact that the plant is in a foreign jurisdiction. Accordingly, the evaluation of whether a legal obligation exists must consider the laws of the foreign jurisdiction, which may or may not include the doctrine of promissory estoppel or a similar concept. In addition, foreign jurisdictions may have other legal requirements related to asset retirements. Accordingly, the enterprise and its legal advisors should evaluate whether it has legal obligations to perform asset retirement activities in each of the locations where it operates.

Partial Settlement and Components of a Larger System

Typically, asset retirement obligations are settled when the associated asset is retired. However, circumstances may exist in which a partial settlement of an asset retirement obligation is required before the complete retirement of the asset. Obligations related to partial asset retirements and retirements of components of a larger system are within the scope of Statement 143. However, the replacement cost of the component is not within the scope of the Statement.

Q4. An enterprise owns and operates a landfill. Regulations require the enterprise to perform certain capping and closure procedures. The enterprise performs capping activities as sections of the landfill become full and effectively are retired. The enterprise will perform closure activities after the entire landfill is retired. Are capping and closure activities within the scope of the Statement?

A. The partial retirement of an asset is within the scope of Statement 143. The implementation guidance in Appendix A of the Statement states that “certain circumstances may exist in which partial settlement of an asset retirement obligation is required or performed before the asset is fully retired.” The fact that partial settlement of an obligation is required or performed prior to the full retirement of an asset does not remove the obligation from the scope of Statement 143. Accordingly, both the capping and the closure activities are within the scope of Statement 143. (Refer to paragraphs A7 and A8 of the Statement.)
**Q5.** An enterprise manufactures an industrial solvent that causes a component in the manufacturing process to become contaminated. State law requires that the enterprise replace the component every three years and dispose of the component in a special hazardous waste site. Is the retirement of the component within the scope of Statement 143?

A. Yes. The retirement of a component of a larger system is within the scope of Statement 143. In many situations, a component may be retired before the retirement of the larger system to which the component belongs. In this question, the enterprise should recognize the obligation to retire and dispose of the component in accordance with Statement 143. However, the cost of the replacement and associated installation costs are not within the scope of Statement 143. (Refer to paragraph A15 of the Statement.)

**Q6.** An enterprise is legally required to dispose of a component of a larger system in a special manner when the component is removed from the system. However, the enterprise is not required legally to remove the component from the system. Does the enterprise have an asset retirement obligation related to the component?

A. Yes. Although the enterprise is not required legally to remove the component from the system, it does have a legal obligation related to the disposal of that component. Accordingly, the enterprise has an asset retirement obligation that should be recognized in accordance with Statement 143. However, the obligation would include only the disposal activities that were legally required to be performed.

The timing of the settlement of the obligation may be uncertain because the enterprise is not legally required to retire the component. However, uncertainty about the timing of the settlement does not eliminate the obligation and may impact the measurement of the liability. Measurement of the liability is discussed in the “Fair Value Measures” section. (Refer to paragraphs 2 and A15 of the Statement.)

**Conditional Obligations**

Certain legal or contractual requirements to perform retirement activities may be conditional obligations that the enterprise ultimately may not be required to perform. Those conditional obligations are within the scope of Statement 143. Uncertainty about whether performance will be required does not eliminate the obligation or defer the recognition of a liability; rather, the uncertainty is considered in the fair value measurement of the liability. For example, contracts between entities may require one of the parties to perform retirement activities when an asset is retired. The non-obligated party to the contract may have the option to waive the provision in the future or the party may have a history of waiving similar contract provisions. Even if the obligated party expects that the retirement provisions will be waived or
will not be enforced, the contract still imposes a legal obligation. Accordingly, the obligated party is required to recognize a liability in accordance with the provisions of Statement 143. However, the likelihood that the party will grant a waiver would affect the measurement of the liability.

**Q7.** An enterprise enters into a timber lease wherein the lessor has an option to require the lessee to settle an asset retirement obligation. The lease grants the lessee the right to harvest timber on a tract of land and grants the lessor the option to require the lessee to reforest the land at the end of the lease. Based on past experience, the lessee believes that the likelihood that the lessor will exercise the option is very low. Should the enterprise recognize a liability for its conditional obligation to reforest the land?

**A.** Yes. A conditional legal obligation to perform asset retirement activities is within the scope of Statement 143. Regardless of the probability that the enterprise will be required to perform the asset retirement activities, it has the obligation to stand ready to perform. Accordingly, liability recognition is based on whether a legal obligation exists. In this question, the lessee should recognize the legal obligation in accordance with Statement 143, and measurement of the obligation would reflect the likelihood that the lessor will waive the requirement to reforest the land. Measurement of the liability is discussed in the “Fair Value Measures” section. (Refer to paragraphs A5, A17, A18, and C10-C12 of the Statement.)

Statement 143 addresses uncertainties about an obligation much differently than FASB Statement No. 5, *Accounting for Contingencies*. Under Statement 5, uncertainties are considered in determining whether a loss has been incurred and whether a liability should be recognized. However, since the liability recognition criteria of Statement 143 is based on “legal obligations,” uncertainties about whether the enterprise would be required to settle the obligation are not considered in determining whether an obligation is recognized. All legal asset retirement obligations, as defined in Statement 143, must be recognized. As discussed in the “Fair Value Measures” section of this guide, Statement 143 requires that uncertainties about whether the enterprise will be required to settle its legal obligation be considered in the measurement of the liability.

**Leasing Transactions**

Lessors who have obligations to perform asset retirement activities associated with leased assets should recognize the obligation in accordance with the provisions of Statement 143. Statement 143 does not apply to asset retirement obligations of a lessee if the obligations meet the definition in FASB Statement No. 13, *Accounting for Leases*, of a minimum lease payment or contingent rental. Statement 13 continues to apply to those obligations. Statement 143 applies to asset retirement obligations of the lessee (whether imposed by the lease or other legal obligations) that are not minimum lease payments or contingent rentals under

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1 FASB Statement No. 13, *Accounting for Leases*, specifically excludes lease agreements that address the rights to explore for or exploit natural resources.
Statement 13. Accordingly, although the property under an operating lease is not recognized on the lessee’s balance sheet, a lessee may have an asset retirement obligation associated with an operating lease.

Provisions in an operating lease may create asset retirement obligations for other assets, such as leasehold improvements. For example, if an enterprise enters into an operating lease for a building, constructs leasehold improvements, and determines based on the provisions of the lease that: (a) it is legally obligated to remove the leasehold improvements at the end of the lease and (b) the costs are not minimum lease payments or contingent rentals, the enterprise has an asset retirement obligation related to the leasehold improvements that should be recognized in accordance with Statement 143. However, if the enterprise is required to remove equipment or other assets that it plans not to retire (e.g., if the equipment would be used at other locations), the costs to remove the equipment are not asset retirement costs and, accordingly, not within the scope of Statement 143.

**Q8.** An enterprise enters into an operating lease for land and the enterprise constructs a communication tower on the land, which it is required to remove at the end of the lease. The enterprise has determined that the tower removal costs are not minimum lease payments or contingent rentals under Statement 13. Is the requirement to remove the tower at the end of the lease term within the scope of Statement 143?

**A.** Yes. The enterprise should recognize the fair value of the liability when the obligation is incurred (i.e., when the tower is constructed). The corresponding asset retirement costs should be added to the cost of the leasehold improvement (i.e., the tower) and the costs should be depreciated over the shorter of the useful life of the tower or the term of the lease.

In practice, the determination of whether a lessee’s obligation is a minimum lease payment or contingent rental under Statement 13 and, therefore, not subject to the provisions of Statement 143 requires judgment. Statement 13 defines minimum lease payments as any obligation to make payments in connection with the leased property. Generally, obligations to dismantle or move a leased asset at the end of a lease are considered minimum lease payments. In contrast, an obligation to return an asset to its condition at the inception of the lease generally is not considered a minimum lease payment. In Question 8, the obligation relates to the leasehold improvements, not the leased asset and, accordingly, the tower removal cost was determined to be an asset retirement obligation, not a minimum lease payment. However, if the enterprise leased both the land and the tower, the obligation to remove the tower is associated with the leased asset and, accordingly, the obligation may be a minimum lease payment and not subject to Statement 143.
Q9. An enterprise enters into an operating lease. Under the lease agreement, the lessor is the primary obligor for the construction of leasehold improvements, and the lessee is required to remove the improvements at the end of the lease term. Is the requirement to remove the improvements at the end of the lease within the scope of Statement 143?

A. No. The obligation to remove the leasehold improvements at the end of the lease term is associated with the leased asset. Accordingly, the obligation generally would be considered a minimum lease payment and, therefore, not within the scope of Statement 143. The enterprise would include the future removal costs in its minimum lease obligation and recognize the removal costs over the term of the lease (generally on a straight-line basis).

Q10. An enterprise enters into an operating lease. Under the lease agreement, the lessor provides the lessee a tenant improvement allowance to construct leasehold improvements. The lessee is the primary obligor for the construction of the improvements and is required to remove the improvements at the end of the lease term. Is the requirement to remove the improvements at the end of the lease within the scope of Statement 143?

A. Yes. The obligation to remove the improvements at the end of the lease is associated with the leasehold improvement, not with the leased asset. Accordingly, the obligation generally would not be considered a minimum lease payment and, therefore, it is within the scope of Statement 143. The enterprise would recognize an asset retirement liability for its obligation to remove the improvements when it incurs the obligation (i.e., when the improvements are constructed).

Rate-Regulated Entities

Statement 143 applies to rate-regulated entities with asset retirement obligations. Therefore, if an enterprise meets the requirements of a regulated entity and the asset is a regulatory asset as defined in FASB Statement No. 71, Accounting for the Effects of Certain Types of Regulation, it should recognize a regulatory asset or liability for timing differences associated with asset retirement obligations recognized in accordance with Statement 143 and the rate-making process.

Q11. Does a legal obligation to perform asset retirement activities exist under the concept of promissory estoppel, if a rate-regulated enterprise includes asset removal costs in its cost of service?

A. Many rate-regulated enterprises historically have included the cost to retire assets in the rates that they charge to customers. If an enterprise includes asset retirement costs for activities that it is not obligated statutorily or contractually to perform in the rates that it charges to its customers, it should evaluate whether it has created a legal obligation to perform those retirement activities under the concept of promissory estoppel.
To determine whether a legal obligation exists under the concept of promissory estoppel, an enterprise should consult with its legal advisors. However, it should be noted that during the deliberations on Statement 143, the FASB recognized that certain retirement costs that rate-regulated entities include in the rates charged to their customers may not qualify for liability recognition under Statement 143 (e.g., nonlegal obligations). Further, the FASB concluded that if an enterprise has asset retirement costs that are included in the rates charged to customers and it has not recognized a liability for the costs under Statement 143, the enterprise should recognize a regulatory liability to the extent that it meets the requirements of Statement 71. (Refer to paragraphs 19, 20, and B73 of the Statement.)

**Alternative Uses, Plans to Dispose and Environmental Obligations**

Activities necessary to prepare an asset for an alternative use are not associated with the retirement of the asset and are not within the scope of Statement 143. The Statement also does not apply to obligations that arise solely from a plan to sell or otherwise dispose of a long-lived asset covered by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*. Obligations that result from the improper use of an asset also are not within the scope of Statement 143. Accordingly, environmental remediation liabilities resulting from “improper” use of an asset generally should be accounted for under AICPA Statement of Position No. 96-1, *Environmental Remediation Liabilities*, not Statement 143. Statement 143 applies to environmental remediation liabilities that result from the “normal” operation of assets and are associated with the retirement of those assets.

**Q12. Does the scope of Statement 143 include environmental remediation activities?**

A. Statement 143 addresses asset retirement obligations that result from the normal use of the asset. It does not address obligations that arise from the improper use of the asset. For example, if an enterprise has incurred environmental remediation obligations related to the closure of a sediment pond that it uses in its manufacturing process, the obligation is within the scope of Statement 143. However, if the enterprise incurred an environmental remediation obligation related to a spill of hazardous waste, the remediation obligation generally would not be within the scope of Statement 143. Environmental obligations that arise outside the normal operation of an asset generally are within the scope of SOP 96-1. In practice, the determination of whether environmental obligations should be accounted for under Statement 143 or SOP 96-1 requires judgment. Accordingly, a company should evaluate all of the facts and circumstances to determine the appropriate authoritative literature. (Refer to paragraphs 2, A12, A13, and B20 of the Statement.)
Q13. Does the scope of Statement 143 include obligations associated with asbestos removal?

A. We believe that Statement 143 may apply to certain obligations associated with asbestos removal activities. If an enterprise is legally obligated to perform asbestos removal or disposal activities in connection with the retirement of a long-lived tangible asset (including components of a larger asset or system), it should recognize the obligation in accordance with Statement 143. If the obligation is not associated with the retirement of a long-lived asset, the enterprise should apply the guidance in EITF Issue No. 89-13, Accounting for the Cost of Asbestos Removal. (Refer to paragraph 2 of the Statement and EITF 89-13.)

There may be differing views on when an enterprise becomes legally obligated to perform asbestos removal obligations. Some believe that the obligating event occurs when the asbestos is removed from the asset and, therefore, a liability should not be recognized until the asbestos is removed. We believe that the obligating event occurs at the acquisition or construction of the asset (or the enactment of the laws or regulations) if the enterprise is obligated to dispose of the asbestos (which may represent a component of the asset) in a specified manner or otherwise contain the asbestos upon retirement of the asset. Those requirements are asset retirement obligations within the scope of Statement 143.

If the enterprise has a legal obligation to dispose of the asbestos, it would be inappropriate to assume that the enterprise will never be required to settle the obligation because the asset does not have an unlimited life (the asset will not last forever) and the ability to defer settlement of the obligation does not eliminate the obligation. (Although the deferral of settlement would impact the measurement of the obligation.) In some cases, the enterprise may plan to sell the building before settlement of the obligation. The sale may result in the transfer of the obligation to the buyer, but the enterprise still has the legal obligation up to the time of sale. Accordingly, the plan to sell the building does not eliminate the obligation.

While we believe that certain asbestos removal obligations may be legal asset retirement obligations within the scope of Statement 143, other firms are not of the same view. (Although, as discussed in the “Initial Recognition and Measurement Section,” that obligation may have an indeterminate settlement date and it may not be possible to make a reasonable estimate of the fair value of the obligation.) We understand that the FASB staff is considering whether further clarification is needed.
Q14. Does the scope of Statement 143 include obligations associated with a plan to sell an asset?

A. The scope of Statement 143 includes legal obligations that result from acquisition, construction, development, or normal operation of the asset and it specifically excludes obligations that arise solely from a plan to dispose of an asset. For example, if an enterprise commits to remove a building in connection with selling a parcel of real estate and it was not otherwise legally obligated to remove the building, the obligation to remove the building is not within the scope of Statement 143. (Refer to paragraph 2 of the Statement.)

Discretionary Activities and Nonlegal Obligations

Under Statement 143, liabilities for asset retirement obligations are recognized only if the enterprise is legally obligated to perform the asset retirement activities. Discretionary retirement activities do not meet the recognition criteria of Statement 143. Accordingly, the enterprise should not recognize a liability for estimated costs of asset retirement activities for which there is no legal obligation. The enterprise generally should recognize the costs of the discretionary retirement activities when the costs are incurred, typically when the activities are performed. (However, as discussed further below, it may be appropriate to consider certain costs in the determination of salvage values.)

Q15. Should an enterprise recognize a liability for costs associated with retiring an asset if it is not required legally to perform the retirement activities?

A. No. Statement 143 requires recognition of a liability if the asset retirement obligation results from a legal obligation to perform asset retirement activities. If an enterprise does not have a legal obligation, as defined in Statement 143, no asset retirement liability should be recognized. Accordingly, an enterprise should not recognize a liability for asset retirement activities it is not legally obligated to perform. (Refer to paragraphs 3, 4, 23, and B73 of the Statement.)

Q16. An enterprise operates a manufacturing plant that it plans to retire in five years. Although the enterprise legally is not obligated to perform asset retirement activities in connection with the plant, it plans to demolish the building and restore the land to its original state. Should the enterprise recognize a liability for the estimated costs to retire the plant through a periodic charge (nondepreciation) to the income statement?

A. The enterprise should recognize a liability for the asset retirement costs only if the obligation meets the recognition criteria of Statement 143. In this instance, the enterprise should not recognize a liability for the estimated costs because it is not obligated legally to perform the activities. The enterprise typically should recognize the dismantling and restoration costs when it incurs the costs. However, such costs may impact the estimated salvage value of an asset.
Q17. An enterprise operates a telephone communications system. Assume that the enterprise legally is not obligated to remove utility poles or to perform any special disposal activities. Should the enterprise recognize a liability for the anticipated costs to remove the utility poles?

A. If the enterprise is not legally obligated to perform the asset retirement activities, it does not have an obligation that meets the liability recognition criteria of Statement 143. In this instance, we have assumed that the enterprise is not legally obligated to remove or to perform special disposal activities related to the utility poles. Accordingly, the enterprise is not legally obligated to perform asset retirement activities associated with these components of a larger system and, therefore, any estimated removal costs do not meet the recognition criteria of Statement 143. As a result, the enterprise should not recognize a liability for the estimated removal costs of the utility poles. In addition, the enterprise should not accrue for these disposal costs as a contra-asset through depreciation and amortization if the costs result in a negative salvage value for the asset. See further discussion below for the effect of Statement 143 on the determination of salvage value.

Q18. An enterprise uses a tangible long-lived asset in its oil and gas producing activities. When the asset is no longer used, the enterprise is obligated legally to perform certain asset retirement activities. May the enterprise continue its existing practice of accruing for the anticipated costs through a depreciation charge and recognizing the resulting credit as a contra-asset account?

A. No. Before the issuance of Statement 143, Statement 19 required oil and gas producing enterprises to include estimated dismantlement, restoration and abandonment costs in their amortization and depreciation rates for their assets. Statement 143 amends Statement 19. In accordance with the amendment, oil and gas producing companies are required to account for estimated dismantlement, restoration and abandonment costs in accordance with Statement 143. Statement 143 does not permit accruing for the legal obligation to perform asset retirement activities as a contra-asset account through depreciation and amortization. As such, oil and gas producing enterprises should discontinue the practice of including those costs in depreciation and amortization rates. Any amounts previously accrued should be reversed upon the adoption of Statement 143. See the “Effective Date and Transition” section for additional discussion on the adoption of Statement 143.

Q19. Does Statement 143 affect the determination of salvage value for an asset?

A. Yes. Although Statement 143 does not address salvage value directly, it does affect the determination of salvage value. In accordance with Statement 143, an enterprise should recognize a liability for a legal obligation to perform asset retirement activities (including removal costs) and it should exclude retirement costs arising from legal obligations from its estimate of salvage value. If the enterprise
SECTION 1: SCOPE OF THE STATEMENT

...were not legally obligated to perform the retirement activities, the costs of the retirement activities may impact the estimated salvage value to the extent that the retirement costs do not reduce the salvage value to below zero. If salvage values were reduced to below zero, the enterprise effectively would have accrued for nonlegal obligations to perform retirement activities, which is not permitted by Statement 143. See additional discussion of salvage values below.

Removal Costs and Salvage Values

In the amendment of Statement 19, paragraph 23 of Statement 143 states that “obligations for dismantlement, restoration, and abandonment costs shall be accounted for in accordance with the provisions of FASB Statement No. 143.” That provision and other provisions of Statement 143 prohibit the recognition of liabilities (or contra-assets) for anticipated costs of asset retirement activities that are not legal obligations. Although the amendment to Statement 19 also refers to consideration of estimated salvage values in determining amortization and depreciation rates, Statement 143 does not provide any guidance on the determination of salvage values or the treatment of removal costs that are not associated with legal asset retirement obligations. The Accounting Standards Executive Committee of the AICPA proposed that asset removal costs be expensed as incurred in an Exposure Draft of a Proposed Statement of Position on “Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment.” However, the final outcome of that proposal is uncertain.

In the past, many enterprises have included estimated costs of activities to remove assets or components of assets that are not legal obligations in the calculation of depreciation. That practice was supported by the provisions of Statement 19 and frequently was applied in other situations, such as in group depreciation methods applied to groups of assets or components of an overall system. In some cases, those removal costs may exceed salvage values, or there may be no value to the components removed from the system. The costs to remove certain components may be incurred to enable the enterprise to install new replacement components to continue to operate the system efficiently or to improve operations of the system. Although the costs must be incurred before the enterprise can sell the components for salvage, the costs may be incurred in connection with the ongoing operation of the overall system rather than to obtain the salvage value of the replaced components. In fact, in situations where the removal costs exceed the salvage value, it would be illogical to treat the removal costs as a cost of obtaining the salvage value. In those cases, the removal costs appear to be associated with the ongoing operations of the system rather than a cost to obtain the salvage value.

As a result of the lack of specific guidance on the determination of salvage values and the treatment of costs to remove assets or components, it is unclear whether enterprises that previously have included estimated removal costs that are not associated with legal asset retirement obligations in depreciation calculations should:
a. Continue to include all removal costs in the depreciation calculations;

b. Exclude all removal costs from the depreciation calculations; or

c. Include removal costs in the depreciation calculations to the extent of salvage values.

We believe that alternative (a) above is not appropriate if the removal costs exceed the salvage value because that would result in recognition of either a liability for nonlegal obligations or a net negative salvage value. Alternatives (b) and (c) may be considered reasonable approaches depending on whether the removal costs are considered to be a cost related to the ongoing operations of the system (which would appear to indicate that all removal costs that are not related to legal obligations should be excluded from the depreciation calculations) or a cost to obtain the salvage value (which would appear to indicate that the removal costs should be treated as a reduction of salvage values, but not below zero).

Although the amendment to Statement 19 in Statement 143 appears to prohibit the recognition of any estimated removal costs that are not related to legal obligations as a liability or a contra-asset, the FASB staff has indicated that they believe that, if an enterprise previously included removal costs in the depreciation calculations, the asset removal costs must be viewed as a cost of obtaining the salvage value and, therefore, those enterprises must continue to include estimated removal costs that are not associated with legal obligations in the depreciation calculations to the extent that the removal costs do not exceed the salvage value. The removal costs in excess of salvage values should be excluded from the depreciation calculations because that excess would result in negative salvage values. According to the FASB staff, Statement 143 would not allow those enterprises to adopt a policy to exclude all removal costs from the depreciation calculations in connection with the adoption of Statement 143. The FASB staff believes such a change would represent a separate accounting change related to the enterprise’s policies on determination of salvage values, not a change related to the adoption of Statement 143.

Consider the following example:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset cost</td>
<td>$1,000</td>
</tr>
<tr>
<td>Removal costs (nonlegal)</td>
<td>$120</td>
</tr>
<tr>
<td>Salvage value</td>
<td>$100</td>
</tr>
</tbody>
</table>

Under prior practice, the enterprise recorded depreciation on $1,020 (asset cost of $1,000 plus removal costs of $120 less salvage value of $100). The FASB staff believes that, under Statement 143, the enterprise should depreciate $1,000 (asset of $1,000 less salvage value of $100 plus removal costs to the extent of salvage of $100). Under this approach, Statement 143 would be applied to $20 of the removal costs (Statement 143 would prohibit recognition of a liability for such costs because they do not relate to legal obligations) but not to $100 of the
same removal costs. If removal costs do not exceed salvage value, the FASB staff believes that the enterprise must continue to include the removal costs in the depreciation calculations even though such costs are not related to a legal obligation.

If an enterprise previously did not include removal costs in its depreciation calculations, that enterprise is not required to include those costs in the estimates of salvage values upon adoption of Statement 143. Such an inclusion would be considered an accounting change pursuant to APB Opinion No. 20, *Accounting Changes*.

**Intent to Hold an Asset and Other Situations**

**Q20.** Does Statement 143 apply to obligations related to activities that an enterprise must perform upon disposal or sale of an asset if it intends to hold the asset for an indefinite period of time?

A. Yes. The intent to indefinitely defer performing the required activities by holding the asset does not exclude those obligations from the scope of Statement 143. However, the uncertainty of the timing of settlement of the obligation may impact the measurement of the liability. The cost of activities that the enterprise is legally required to perform to contain environmental contamination after the retirement of the related asset should be included in the estimated costs of the asset retirement obligation.

**Q21.** If an enterprise sells a product for which it retains a legal obligation to perform a future disposal activity, should it recognize an asset retirement obligation?

A. The scope of Statement 143 includes the accounting for asset retirement obligations related to tangible long-lived assets. Since the disposal obligation in this question relates to a product that has been sold, the obligation is not within the scope of Statement 143. Accordingly, the enterprise should not record an asset retirement liability for this obligation. However, the enterprise may need to record a liability (or defer revenue) for its obligation related to the sold product. (Refer to paragraph 2 of Statement 143.)
Initial Recognition and Measurement of the Liability

Asset retirement obligations within the scope of Statement 143 include those that result from the acquisition, construction, development or normal use of an asset. Statement 143 requires an enterprise to recognize the fair value of an asset retirement obligation as a liability in the period in which it is incurred, if a reasonable estimate of fair value can be made. An enterprise should display the obligation as a liability, not as a contra-asset account. Since the requirement in Statement 143 is to recognize the asset retirement obligation when it is incurred, previous methods that accrued the obligation over the life of the asset are no longer acceptable.

If the enterprise cannot make a reasonable estimate of fair value in the period in which the obligation is incurred, it should recognize the liability in a subsequent period when a reasonable estimate can be made. The Statement requires an enterprise to disclose certain information when a reasonable estimate cannot be made.

The consideration of probability in the recognition and measurement of liabilities is different in Statement 143 than practice under Statement 5. In Statement 5, probability is considered to determine whether a contingent liability should be recognized (i.e., probability of loss). In Statement 143, probability is considered in the measurement of the fair value of the liability. For example, if there were only a 10 percent chance that an enterprise would be required to pay (or use other assets) to satisfy a legal obligation to retire an asset, the enterprise would be required to recognize a liability for the obligation and the probability of payment would be incorporated in the measurement of the liability. Uncertainties about performance of a conditional obligation do not prevent an enterprise from making a reasonable estimate of the liability.

Asset Retirement Obligations With Uncertain or Indeterminate Settlement Dates

Statement 143 requires an enterprise to recognize an asset retirement obligation in the period in which it is incurred if a reasonable estimate of fair value can be made. Situations may occur in which an enterprise is uncertain about the timing of the settlement of the asset retirement obligation. However, uncertainty about the timing of the settlement does not remove the obligation from the scope of Statement 143. As discussed further in the Fair Value Measures section of this guide, the Statement encourages an enterprise to use the expected cash flow technique to estimate the value of the liability. The expected cash flow technique allows an enterprise to assign probability factors to various potential cash flows (including the timing of the cash flows) to estimate fair value of the cash flows. Accordingly, the expected cash flow technique can incorporate the uncertainty of the settlement date of an asset retirement obligation into the fair value estimate.

However, situations may occur in which an enterprise has insufficient information regarding the settlement date to make a reasonable estimate of the fair value of the asset retirement obligation. For example, an enterprise may have an asset retirement obligation related to a manufacturing plant location at which it intends to operate indefinitely.
Additionally, a range of potential settlement dates may not exist. In this instance, the enterprise has an asset retirement obligation for which there may not be enough information to make a reasonable estimate of the fair value. If the enterprise cannot reasonably estimate a range of settlement dates to estimate fair value, it should recognize a liability in the period in which a reasonable estimate can be made and depreciate the associated asset retirement costs over the remaining useful life of the asset. Prior to recognition, the enterprise should disclose why the obligation could not be reasonably estimated. (Refer to paragraphs 3, 22, A14 and A16 of the Statement.)

Q22. What factors should an enterprise consider in its evaluation of whether an asset retirement settlement date is indeterminate?

A. An enterprise should consider carefully all of the facts and circumstances in its evaluation as to whether the settlement date of an asset retirement obligation is indeterminate. These factors may include:

- Historical performance and experience with similar assets;
- Budgets, forecasts and long-term planning;
- Effect on financial performance;
- Economic viability of the asset and related products;
- Depreciable useful life of the asset;
- Anticipated changes in the use of the asset;
- Planned maintenance and replacement of the asset or components;
- Estimated changes in technology and associated risk of obsolescence;
- Contractual requirements;
- Regulatory requirements and licenses; and
- Public opinion.

Additionally, if an asset has an indeterminate useful life, the enterprise should consider whether asset retirement obligations exist for components of the asset. For example, an enterprise may conclude that an asset retirement obligation at its production facility has an indeterminate settlement date because it plans to operate that facility indefinitely. However, for the facility to continue to operate, the enterprise may be required to replace the plant or components of the production system. Accordingly, the enterprise should evaluate whether asset retirement obligations exist for the facility or components of the system.
Q23. If an enterprise plans to operate a plant at a site indefinitely and there is a sediment pond at the site for which it is legally obligated to perform asset retirement activities, should the enterprise recognize a liability for the future costs?

A. Uncertainty about the timing of the settlement of the asset retirement obligation does not remove the obligation from the scope of Statement 143. The enterprise should recognize a liability in the period in which it incurs a legal obligation to perform the asset retirement activities if a reasonable estimate of the fair value of the obligation could be made. In this instance, the enterprise plans to operate the plant indefinitely and, accordingly, the settlement date of the asset retirement obligation may not be known. (See Question 22 for factors that an enterprise should consider in its evaluation of whether the settlement date of an asset retirement obligation is indeterminate.) If the enterprise can determine a range of potential settlement dates, it typically can estimate the fair value of the liability by using the expected cash flow method. To the extent that the enterprise cannot make a reasonable estimate of fair value of the liability, it should recognize the liability in the period in which a reasonable estimate of fair value can be made and depreciate the associated asset retirement costs over the remaining useful life of the asset. The enterprise is required to disclose that an asset retirement obligation exists and that it is unable to estimate the fair value of the liability and the reason why a reasonable estimate cannot be made. (Refer to paragraphs 3, 22, A14 and A16 of the Statement.)

Q24. An enterprise operates a manufacturing plant that it currently is depreciating over 40 years. The enterprise is legally obligated to perform retirement activities when the plant ceases operations. Does the depreciable life of the asset establish the settlement date of the asset retirement obligation?

A. The depreciable life of an asset is one of many factors that an enterprise should consider when estimating the settlement date of the asset retirement obligation. The enterprise should consider the nature of the legal obligation, the activities required to be performed, and the factors described in Question 22 in determining the anticipated settlement dates. If the depreciable life of the asset were significantly different than the timing of the settlement of the obligation, the enterprise would need to reconsider whether the depreciable life was appropriate. In certain cases, the obligation may relate to the plant site rather than the building. In those cases, the settlement date may not correspond to the end of the useful life of the building.

Q25. An enterprise plans to cease operations at a manufacturing facility. Remediation activities are required legally only if title of the property is transferred. If the enterprise plans to retain title to the property for the foreseeable future, should it recognize a liability for the asset retirement costs?
A. Uncertainty about the timing of the settlement of the asset retirement obligation does not remove the obligation from the scope of Statement 143. The enterprise should recognize the liability in the period in which in incurs the obligation to perform the asset retirement activities if a reasonable estimate of the fair value of the liability can be made. In this situation, the enterprise plans to retain title to the property and, accordingly, the settlement date of the asset retirement obligation may be unknown. Management should evaluate its ability to hold the property, including the effect of holding the property on its financial performance (e.g., return on assets and capital) and its historical practice with similar assets.

If management can determine a range of potential settlement dates, it typically can estimate the fair value of the liability by using the expected cash flow method. To the extent that the enterprise cannot make a reasonable estimate of the potential settlement dates (and fair value), it should recognize the liability in the period in which a reasonable estimate of fair value can be made. The enterprise is required to disclose that an asset retirement obligation exists for which it is unable to reasonably estimate its fair value and the reasons why a reasonable estimate cannot be made.

Q26. An enterprise owns and operates a manufacturing facility that contains asbestos. If the enterprise dismantles the facility, the asbestos legally requires special handling. The enterprise plans to sell the facility in five years and, accordingly, it will not be required to perform any activities related to the asbestos. Should the enterprise record an asset retirement obligation related to the asbestos?

A. The enterprise should recognize an asset retirement obligation in accordance with Statement 143 if there is a legal obligation to perform asset retirement activities (see Q13.). A plan that avoids the ultimate settlement of the obligation does not remove the obligation from the scope of Statement 143. The enterprise should estimate the fair value of the asset retirement liability based on the estimated settlement date of the obligation. In this situation, the estimated settlement date is beyond the five years that the enterprise intends to own the facility. It is assumed that the buyer of the facility would incorporate the asset retirement obligation in its determination of the purchase price of the facility and it would reduce its purchase price accordingly. As such, the enterprise cannot avoid recording the liability for the asset retirement obligation based on an anticipated sale of the facility.
Obligations Recorded as Incurred

Statement 143 requires an enterprise to recognize the fair value of an asset retirement liability in the period in which it incurs the obligation. Generally, the obligation is incurred through the acquisition, construction, development, or normal use of an asset. Additionally, an obligation can be incurred by the enactment of a new law or regulation.

If an enterprise acquires a long-lived asset with an existing asset retirement obligation (either through an asset acquisition or a business combination), it should recognize the fair value of the liability for that obligation on the date that it acquires the asset. The acquiror’s estimate of the fair value of the obligation may differ from the asset retirement liability previously recognized by the seller because of different interest rates and assumptions about the timing of settlement of the obligation.

An enterprise may also incur asset retirement obligations during the normal operations of the asset. If events that create the retirement obligation occur in more than one reporting period, the enterprise should measure and recognize the fair value of the incremental liability in each reporting period, thereby recording additional layers of liability.

Q27. An enterprise acquires an operating mine and assumes a legal obligation to perform asset retirement activities for the past operations of the mine. Because the enterprise assumes a legal obligation to perform asset retirement activities, it should recognize an asset retirement obligation in the period that it acquires the mine. When operating the mine, the enterprise periodically closes sections of the mine, effectively retiring the section, and opens new sections of the mine. The enterprise incurs additional retirement obligations when it opens a new section of the mine. When should the enterprise recognize the asset retirement obligations for the new sections of the mine?

A. The enterprise should recognize additional asset retirement obligations in the periods in which it incurs additional legal obligations to perform asset retirement activities. In this instance, the enterprise should recognize an additional obligation in the period in which it opens a new section of the mine. The enterprise should recognize the additional obligations as additional layers of the asset retirement liability and additional asset retirement costs. (Refer to paragraphs 3 and A11 of the Statement.)

If an enterprise incurs an asset retirement obligation by constructing or developing a long-lived asset over a number of reporting periods, the enterprise should recognize the fair value of the obligation that has been incurred at the end of each reporting period. As the construction or development of the long-lived asset progresses, the enterprise may incur additional asset retirement obligations. For these additional obligations, the enterprise should measure and
record the fair value of the incremental obligations as additional layers of liability. An enterprise may be required to make numerous measurements of the liability based on its obligations at the end of each period.

Q28. An enterprise constructs a factory that it is obligated legally to remove at the end of the useful life of the factory. At the end of the first period, the foundation of the factory is complete. The foundation represents 20 percent of the total construction costs and 40 percent of the future removal costs. How much of the asset retirement obligation should the enterprise recognize at the end of the first period?

A. Regardless of the percentage of completion of the factory, the enterprise should recognize the full fair value of its obligation to remove the foundation. In this instance, the liability should represent 40 percent of the fair value of the total factory removal obligation, which is the fair value of the liability to remove the foundation. The Statement prohibits the enterprise from recognizing only 20 percent (based on the relationship of incurred costs to total estimated costs) of the fair value of the total future asset retirement obligation at the end of the first period. The enterprise should recognize additional layers of liability as it continues to construct the factory.

An enterprise may incur an asset retirement obligation due to the enactment of a new law or regulation. In that event, the enterprise should recognize an asset retirement liability in the period in which the new law or regulation is enacted. The enterprise should not anticipate the enactment of a new law or regulation. That is, the enterprise should not recognize a liability for an anticipated law or regulation (even if the enactment of the law or regulation is probable). Upon recognition of the asset retirement liability, the enterprise would recognize the associated asset retirement cost and depreciate that asset retirement cost over the remaining useful life of the asset on a systematic and rational basis.

Activities Included in the Obligations

The liability for an asset retirement obligation should include only the activities required to satisfy the legal obligation. The determination of whether a cost should be included in the asset retirement obligation is not always clear. For example, if a law requires an enterprise to dispose of a manufacturing component in a hazardous waste landfill, the enterprise should include the cost of the landfill fee and the related transportation in the measurement of its asset retirement obligation. Additionally, depending on the facts and circumstances, the enterprise also may need to include the removal cost of the component in its asset retirement obligation. The Statement does not specifically address whether removal and dismantling costs are considered asset retirement obligations. However, the Statement specifically excludes obligations associated with the maintenance, rather than the retirement, of the long-lived asset. We believe that an enterprise needs to consider all of the relevant facts and circumstances to determine whether the removal and dismantling cost is part of the legal obligation associated with the retirement of a long-lived asset. In this example, we believe that if the enterprise does
not need to remove the component except to satisfy its legal obligation, the enterprise generally should include the removal cost in its asset retirement obligation. However, if the component is replaced as part of the regular maintenance of the facility (e.g., every three years), our view is that the enterprise generally should not include the removal costs in its asset retirement obligation.

Q29. *When determining the fair value of an asset retirement obligation, can an enterprise reduce the fair value of the liability for the estimated salvage value of an asset?*

A. No. The estimated salvage value of an asset should not be considered in determining the fair value of an asset retirement liability. An enterprise should consider the estimated salvage value of an asset in determining the appropriate depreciation charges for that asset.
Fair Value Measures

Statement 143 requires that asset retirement obligations initially be recognized at fair value. The Statement defines the fair value of a liability for an asset retirement obligation as the amount at which that liability could be settled in a current transaction between willing parties. An enterprise must recognize the liability at fair value even if it plans (or is required) to use its own internal resources to settle the obligation. This represents a change to the current practice of certain enterprises that estimate retirement liabilities based on the internal costs that will be required to satisfy the future obligation.

The best evidence of fair value is quoted market prices in active markets and an enterprise should use the market price as the basis of measurement if it is available. If a quoted market price is not available, the estimate of fair value should incorporate the best information available, including prices of similar obligations and present value (or other valuation) techniques.

Cash Flow Estimates

Statement 143 asserts that in the absence of quoted market prices, present value techniques are often the best available measure of fair value. Statement 143 refers to the present value techniques in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, which discusses two present value techniques, the traditional approach and the expected cash flow approach. The traditional technique uses a single set of cash flows and a single (risk adjusted) interest rate to estimate fair value. The expected cash flow approach uses multiple cash flows that reflect a range of possible outcomes and a credit-adjusted risk-free interest rate to estimate fair value. Because the FASB believes it would be rare, if ever, that there would be an observable rate of interest relevant to the traditional approach, the expected cash flow approach may be the most appropriate technique to measure an asset retirement obligation.

Because the objective of initial measurement is fair value, an enterprise should use market-based assumptions in the cash flows that it uses to estimate fair value, if those assumptions are available without undue cost or effort. If market-based assumptions are not available, an enterprise should use reasonable and supportable assumptions. Because the objective in the fair value measurement is to estimate the amount a third party would demand to assume the asset retirement obligation, an enterprise’s cash flows should include explicit assumptions about the following:

- A third party’s costs to perform the retirement activities, including the costs that the third party typically would consider to determine a price (e.g., overhead, profit margin, inflation and changes in technology);
- The extent to which those costs or the timing of those costs would vary under different scenarios and the relative probabilities associated with those scenarios; and
c. The price a third party would demand for bearing the uncertainties and unforeseeable circumstances inherent in settling the future obligation (i.e., market risk premium).

If an enterprise estimates a range of possible cash flows, it should develop a cash flow model that considers the likelihood and uncertainty of the possible outcomes within that range. For example, if a contract includes an option for the counterparty to waive the retirement obligations of an enterprise, the enterprise would incorporate the probability that it will receive the waiver in its expected cash flows. If the enterprise receives the waiver, the cost to the enterprise will be zero. If the enterprise does not receive the waiver, the enterprise estimates (based on a detailed analysis) that the cost to satisfy the obligation is $300,000. The enterprise estimates that the probability of receiving the waiver is 50 percent. Therefore, the expected cash flow is $150,000 (i.e., $(50\% \times $300,000) + (50\% \times $0) = $150,000$).

Q30. Can an enterprise anticipate advances in technology when estimating the future cash flows of an asset retirement obligation?

A. The measurement objective of fair value is to determine the amount a third party would demand to assume an asset retirement obligation. Accordingly, an enterprise should incorporate third-party assumptions in the cash flows that are used to estimate fair value. If it were reasonable (and supportable) to assume that a third party would anticipate advances in technology in determining the amount that it would demand to assume the asset retirement obligation, then the enterprise should include the anticipated technological improvements in its estimate of fair value. (Refer to paragraphs 9 and A20 of the Statement.)

Q31. An enterprise enters into a lease and constructs leasehold improvements. The lease requires the enterprise to remove the leasehold improvements at the end of the lease. Management determines that the removal costs are not minimum lease payments or contingent rents and, accordingly, the obligation is an asset retirement obligation. Can an enterprise anticipate lease renewals when estimating the fair value of the obligation?

A. The measurement objective of fair value is to determine the amount a third party would demand to assume an asset retirement obligation. Accordingly, an enterprise should incorporate third-party assumptions in the cash flows that are used to estimate fair value. If it were reasonable (and supportable) to assume that a third-party would factor a lease renewal(s) into its estimate, the enterprise should incorporate the lease renewal(s) into its cash flows. That is, the likelihood of the lease renewal should be incorporated in the expected cash flows, which would reflect the probability of the different settlement dates. An option to renew the lease is not required to anticipate a renewal in the expected cash flows; however, the probability associated with the lease renewal should reflect whether a renewal option exists. That is, the probability of renewing the lease without a renewal option generally would be less than if a renewal option existed. In contrast to anticipating
renewals for the fair value measurement, the capitalized asset retirement costs generally should be depreciated over the shorter of the lease term or the estimated useful life of the improvements.

**Market Risk Premium**

Statement 143 indicates that an enterprise should include a market risk premium in its expected cash flows to estimate the fair value of an asset retirement obligation. A *market risk premium* is the premium that a contractor would demand for bearing the uncertainty of settling a future obligation for today’s fixed price. However, Statement 143 provides little guidance on how to determine the market risk premium. Concepts Statement 7 states that there may be many techniques for estimating a market risk premium; however, in many cases, a reliable estimate of the amount may not be obtainable. If a reliable estimate of the market risk premium cannot be made, the best available estimate of the fair value of the obligation may be the estimated future cash flows excluding the market risk premium. (Refer to paragraphs A20 and C3 of Statement 143 and paragraph 62 of Concepts Statement 7.)

**Discount Rate**

After estimating the future cash flows that would be required to satisfy the retirement obligation, the enterprise should discount the cash flows using a credit-adjusted risk-free interest rate for maturity dates that coincide with the expected cash flows required to satisfy the asset retirement obligation. The credit-adjusted risk-free interest rate reflects the specific entity’s credit standing. In the United States, the risk-free rate is the rate for zero-coupon U.S. Treasury instruments.

Statement 143 and Concepts Statement 7 provide little guidance on adjusting the risk-free interest rate for the credit standing of an enterprise. However, the enterprise’s incremental borrowing rate for debt with maturities similar to the anticipated settlement dates of the asset retirement obligation may be a reasonable estimate of the credit-adjusted, risk-free interest rate.

If the estimated cash flows include uncertainty as to the timing of the cash flows, it may be necessary to apply different discount rates for the different potential settlement dates. In those situations, it may be necessary to use a weighted-average interest rate to accrete the liability.

**Q32.** A subsidiary has an asset retirement obligation. What credit-adjusted, risk-free interest rate should the subsidiary use?

A. The risk-free interest rate should be adjusted to reflect the credit risk of the entity that is legally obligated to perform the asset retirement activities. Accordingly, if the subsidiary were the obligated entity, the credit-adjusted, risk-free interest rate would reflect the credit standing of the subsidiary. However, if the consolidated entity were
legally obligated in the event that the subsidiary defaults, the credit-adjusted, risk-free interest rate would reflect the credit standing of the consolidated entity. That is, an enterprise should use an interest rate that reflects the return a third party would demand to lend money to the entity that is obligated to perform the asset retirement activities. (Refer to paragraphs 8, 9 and A21 of the Statement.)

Illustration 1—Fair Value Calculation

On January 1, 2003, an enterprise completes construction of an offshore oil platform and places it into service. The enterprise legally is required to dismantle and remove the platform at the end of its useful life, which is estimated to be ten years. The enterprise intends to use its internal resources to dismantle and remove the platform at the end of its life. Because the legal obligation results from the construction, and not the operation, of the oil platform, the enterprise recognizes the fair value of the retirement obligation and capitalizes this amount as part of the cost of the asset during the construction period. A quoted market price is not available; therefore, the enterprise estimates the fair value of the liability using an expected cash flow, present value technique. The objective of this calculation is to estimate the amount a third party would demand to assume the obligation (regardless of the fact that the enterprise intends to use internal resources to retire the asset).

a. Labor costs are based on the current market rates to hire individuals to dismantle and remove offshore oil platforms. The enterprise assigns probability assessments to a number of potential cash flows:

<table>
<thead>
<tr>
<th>Cash Flow Estimate</th>
<th>Probability Assessment</th>
<th>Expected Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>25%</td>
<td>$25,000</td>
</tr>
<tr>
<td>125,000</td>
<td>50%</td>
<td>62,500</td>
</tr>
<tr>
<td>175,000</td>
<td>25%</td>
<td>43,750</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$131,250</td>
</tr>
</tbody>
</table>

b. The enterprise allocates overhead and equipment charges at 80 percent of the labor charge. The enterprise believes that this rate is consistent with overhead and equipment charges applied by contractors that do this type of work.

c. The enterprise includes an estimated profit margin of 20 percent, which is management’s understanding of a contractor’s typical profit margin for this type of work.
d. The enterprise believes that a contractor typically would demand a premium of 5 percent for bearing the uncertainty inherent in “locking in” today’s price for a project to be undertaken in ten years. No changes in technology are expected.

e. The risk-free interest rate at January 1, 2003 is 5 percent (i.e., the rate for a zero-coupon U.S. Treasury instrument with a ten-year maturity). The enterprise adjusts this rate by 3.5 percent to reflect its credit standing. Thus, the credit-adjusted risk-free interest rate that the enterprise uses for the present value calculation is 8.5 percent.

f. The enterprise assumes an inflation rate of 4 percent over the ten-year period.

<table>
<thead>
<tr>
<th>Expected Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected labor costs</td>
</tr>
<tr>
<td>Allocated overhead and equipment charges</td>
</tr>
<tr>
<td>($131,250 x .80)</td>
</tr>
<tr>
<td>Contractor’s markup ([($131,250 + $105,000] x .20)</td>
</tr>
<tr>
<td>Expected cash flows before inflation adjustment</td>
</tr>
<tr>
<td>Inflation factor assuming 4 percent for 10 years</td>
</tr>
<tr>
<td>Expected cash flows adjusted for inflation</td>
</tr>
<tr>
<td>Market risk premium ($419,637 x .05)</td>
</tr>
<tr>
<td>Expected cash flows, adjusted for market risk</td>
</tr>
<tr>
<td>Present value using a credit-adjusted risk-free rate of 8.5 percent for 10 years</td>
</tr>
</tbody>
</table>

Based on this calculation, the enterprise would record a liability of $194,879 for the fair value of its asset retirement obligation and would record an increase in the cost basis of the oil platform in the same amount. (Refer to paragraphs C3 – C4 of the Statement.)

The above illustration demonstrates the potential complexity of measuring the fair value of an asset retirement obligation. If there is not an established market, the enterprise may have a history of removing offshore oil platforms that provides it with sufficient knowledge to make reliable estimates. However, estimating the fair value of an asset retirement obligation becomes
much more difficult for an enterprise that does not have a history with these activities. For example, a newly formed enterprise that operates a special purpose asset may not have any experience with retiring a similar asset. In this situation, the enterprise may be required to expend significant cost and effort to develop reasonable assumptions for the fair value calculation.

Where assets with asset retirement obligations are components of a larger group (for example, oil wells that comprise an oil field), Statement 143 permits aggregation techniques and computational shortcuts to estimate fair value if such techniques and shortcuts are consistent with the fair value objective of the standard. (Refer to paragraph A22 of Statement 143.)

**Gains or Losses on Settlement**

The use of fair value to measure the asset retirement obligation was one of the most contentious aspects in the development of Statement 143. The fair value approach required by the Statement may result in gain recognition if the enterprise ultimately uses its own resources (e.g., internal workforce) to settle the asset retirement obligation. The FASB recognizes that the use of marketplace assumptions in the estimated cash flows results in the capitalization of a third party’s overhead and gross profit margin. Therefore, if an enterprise intends to use its own resources to settle the obligation, the settlement typically results in a gain to the extent that its labor costs are less than the estimated third-party amounts. In arriving at this conclusion, the FASB members were concerned that identical obligations would be recognized at different amounts by enterprises based solely on the intended method of settlement. As a result, the Statement requires the amount of the liability to be the same (assuming the same credit-adjusted risk-free interest rate) without regard to how an enterprise intends to settle the liability, and the enterprise recognizes the efficiencies of settling a liability using its own internal resources at settlement, not before.
Illustration 2 – Gain or Loss on Settlement

As indicated in Illustration 1, the enterprise recognized a $194,879 liability for the fair value of an asset retirement obligation related to an offshore oil platform. The enterprise intends to use its own internal workforce to settle the obligation at the end of the asset’s ten-year life. However, in accordance with Statement 143, the recognized liability includes estimated cash flows for a contractor’s overhead and gross profit margin.

On December 31, 2012, the entity settles its asset retirement obligation using its internal workforce at a cost of $350,000. We have assumed that the enterprise had no changes in the estimated cash flows used to calculate fair value during the ten-year period of operations. The liability increased to $440,619 over the period due solely to the passage of time (i.e., accretion). Upon settlement of the obligation, the enterprise records a gain of $90,619, which is calculated as follows (Refer to paragraphs C5 - C7 in the Statement.):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal labor costs</td>
<td>$195,000</td>
</tr>
<tr>
<td>Allocated overhead and equipment charges at 80% of labor</td>
<td>155,000</td>
</tr>
<tr>
<td>Total costs incurred</td>
<td>350,000</td>
</tr>
<tr>
<td>Asset retirement obligation at 12/31/2012</td>
<td>440,619</td>
</tr>
<tr>
<td>Gain on settlement</td>
<td>$90,619</td>
</tr>
</tbody>
</table>
Recognition, Allocation and Asset Impairment

Upon initial recognition of a liability for an asset retirement obligation, an enterprise should capitalize the asset retirement cost with the corresponding increase in the carrying amount of the related long-lived asset. That is, the initial asset retirement cost becomes a part of the carrying amount of the asset. That cost is then allocated to operating expense (i.e., depreciation) on a systematic and rational basis over the remaining useful life of the asset. As such, an enterprise generally is precluded from capitalizing and writing-off 100% of the asset retirement cost in the year of acquisition.

Allocation of Asset Retirement Costs

Statement 143 does not provide specific guidance on how the asset retirement cost is to be allocated (depreciated), other than to require that the allocation be systematic and rational. For example, an enterprise may depreciate the asset retirement costs using the same method that it uses to depreciate the associated asset (e.g., straight-line, accelerated or units of production). There may be additional alternatives to consider in cases where the obligation is incurred over the life of the asset. If the asset retirement obligation occurs over the life of the asset, the application of a systematic and rational allocation method does not preclude an entity from capitalizing the amount of asset retirement costs and charging an equal amount to expense in the same period. However, Statement 143 prohibits an enterprise from expensing the asset retirement costs without capitalizing the costs to the related asset.

Q33. An enterprise acquires a landfill with an estimated life of ten years. At acquisition, the enterprise incurs an asset retirement obligation related to the past operations of the landfill. The enterprise recognizes the asset retirement obligation, adds the corresponding amount to the carrying amount of the asset, and depreciates this amount on a systematic and rational method over the ten-year life of the landfill. The enterprise also will incur additional asset retirement obligations as it operates the landfill. One-tenth of the additional asset retirement obligations will be incurred each year. How should the enterprise depreciate the asset retirement costs for the additional layers of liabilities that are incurred as it operates the landfill?

A. Statement 143 permits different methods of accounting for the asset retirement costs that the enterprise will recognize during the operation of the asset. The enterprise is required to recognize a new layer of the asset retirement obligation (the liability) and a new layer of the asset retirement cost at the end of each period as the additional obligation is incurred. The additional asset retirement cost could be depreciated over the remaining life of the asset. For example, at the end of year one, the enterprise would recognize a liability for one-tenth of the asset retirement obligation, add the corresponding amount to the carrying amount of the asset and depreciate this amount over the remaining nine years of the useful life of the asset. At the end of year two, the enterprise again would recognize one-tenth of the asset retirement obligation, add the corresponding amount to the carrying amount of the asset and depreciate this amount over the remaining eight years of the useful life of
the asset. This method increases depreciation expense over the useful life of the asset. Under an alternative method, the enterprise would capitalize and then expense one-tenth of the asset retirement cost each year, which would reduce the bookkeeping requirements and straight-line the expense related to the asset retirement obligation that it incurs by operating the landfill.

The response to Question 33 also is applicable to other operations that incur additional layers of liability through the operation of an asset (e.g., certain mining operations).

**Q34.** If an enterprise anticipates that it will perform asset retirement activities in 20 years related to an asset that has a useful life of 15 years, over how many years should the enterprise depreciate the asset retirement costs?

A. Asset retirement costs should be amortized over the life of the related asset, not over the period to the settlement date. After the initial recognition of an asset retirement liability, an enterprise is required to allocate asset retirement costs to expense using a systematic and rational method. Asset retirement costs do not provide a separate economic benefit and, accordingly, do not qualify as a separate asset beyond the economic life of the tangible long-lived asset. Asset retirement costs are integral to the operation of the tangible long-lived asset and should be amortized over the life of the tangible asset. In this instance, the asset retirement costs should be amortized over the 15-year useful life of the asset. (Refer to paragraphs 11 and B42 of the Statement.)

**Q35.** If a component of a larger system has an asset retirement obligation and the component has a shorter useful life than the larger system, should an enterprise depreciate the asset retirement costs over the useful life of the component or the system?

A. Since the retirement obligation relates to the component, and not the system, the enterprise should depreciate the asset retirement costs on a systematic and rational method over the useful life of the component. (Refer to paragraph 11 of the Statement.)

**Q36.** An enterprise enters into a lease and constructs leasehold improvements. The lease requires the enterprise to remove the leasehold improvements at the end of the lease and the enterprise has recognized an asset retirement obligation for the removal of the improvements. If the enterprise has incorporated potential lease renewals in the determination of the fair value of the obligation, over what period should the enterprise depreciate the asset retirement costs that are added to the cost basis of the improvements?
A. The enterprise should depreciate the asset retirement costs over the useful life of the related asset. In this instance, the enterprise should depreciate the asset retirement costs over the useful life of the leasehold improvements, which generally is over the shorter of the useful life of the improvements or the lease term. (Refer to paragraph 11 of the Statement.)

Impairment Considerations

An enterprise should apply the provisions of Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, to the carrying amount of the long-lived tangible assets including any capitalized asset retirement costs. To avoid double-counting the asset retirement costs in the Statement 144 impairment tests, an enterprise should adjust the cash flows to exclude the cash flows underlying the asset retirement obligation that has been recognized in the financial statements from the undiscounted cash flows used to test for recoverability and from the discounted cash flows used to measure the fair value of the asset. If an enterprise uses a quoted market price to determine the fair value of the asset in the impairment test and the quoted market price reflects the effect of the costs that will be incurred to retire the asset, it should increase that value by the fair value of the asset retirement obligation for purposes of measuring impairment. This approach is consistent with general asset acquisition accounting, which requires that the cost (and thus, fair value) of an asset includes not only any consideration paid to acquire it, but also any liabilities assumed in connection with acquiring it.

However, if an enterprise has not recognized a liability for asset retirement costs because it has not incurred the obligation or the obligation does not meet the recognition criteria of Statement 143, it should consider the likelihood of possible outcomes in its impairment analysis. For example, if an enterprise has available alternative courses of action related to asset retirement activities that are not legal obligations, it should weigh the cash flows based on the probabilities of the potential outcomes for the Statement 144 impairment tests. (Refer to paragraph 12 of the Statement and EITF Issue No. 95-23, *The Treatment of Certain Site Restoration/Environmental Exit Costs When Testing a Long-Lived Asset for Impairment.*)
Subsequent Recognition and Measurement

In periods after the initial measurement, an enterprise should recognize period-to-period changes in the asset retirement liability that result from (a) the passage of time and (b) revisions to either the timing or amount of the original estimate of undiscounted cash flows. The enterprise should measure and record changes due to the passage-of-time (accretion expense) before measuring the changes to the liability that are due to revisions in the undiscounted cash flows. An enterprise generally does not recognize an immediate expense or benefit resulting from a change in the estimated cash flows for a retirement obligation. Any changes to the estimated cash flows generally will affect future period expense through depreciation.

Interest Method

An enterprise should record changes to the retirement obligation due to the passage of time by applying the interest method. The enterprise should measure the magnitude of this change using the credit-adjusted risk-free interest rate that existed when it established the liability and the liability balance at the beginning of the period. The enterprise should record the resulting increase in the liability with a corresponding charge to operating expense, which should be included as a component of operating income. An enterprise should use a description for the passage of time expense that conveys the nature of the expense. The Statement refers to this expense as “accretion.” This accretion expense is not to be reported as interest expense in the statement of operations.

The interest-method approach in Statement 143 is not a fresh-start approach. Therefore, the liability is not remeasured at fair value each period. Instead, the liability is adjusted for the passage of time using the interest method. In addition, the liability is adjusted for changes in the estimated undiscounted cash flows that were used in the initial fair value measurement. Such adjustments are made for changes in the estimates of the timing, amount, and probability of the cash flows. However, changes solely in interest rates do not result in adjustments to the previously recognized liability.

Changes in Estimates

Based on the requirement to adjust the liability for changes in estimated timing or amounts of cash flows, an enterprise should evaluate its estimates of cash flows each reporting period to determine whether the estimates are still appropriate. This evaluation should consider all changes in facts and circumstances, including changes in the market and the underlying assumptions (e.g., probability assessments) used in the valuation and changes to the estimated settlement dates. Therefore, enterprises will be required to establish systems to track and monitor on a regular basis changes in the estimated cash flows of its asset retirement obligations.
Q37. How often should an enterprise monitor existing asset retirement obligations to determine if there has been a change in the estimated cash flows of the obligation?

A. An enterprise should evaluate its estimates of cash flows each reporting period to determine whether the estimates are still appropriate. (Refer to paragraphs 13 and A25 of the Statement.)

The use of a quoted market price to measure the fair value of the asset retirement obligation presents additional complexities when remeasuring the liability for changes in estimates. Because Statement 143 uses the interest-method approach to remeasure the asset retirement obligation, changes in the quoted market price must be evaluated based on the undiscounted cash flows and the timing of those cash flows. Effectively, the enterprise must impute undiscounted cash flows for the initial fair value measurement and for subsequent changes in market price. The Statement provides an illustrative example to impute cash flows.

If the original estimate of undiscounted cash flows changes, the enterprise should recognize an increase or decrease in the carrying amount of the liability and the related asset. Changes to the asset-carrying amount are depreciated on a prospective basis. An enterprise should discount upward adjustments of the estimated cash flows using its current credit-adjusted risk-free interest rate. An enterprise should discount downward adjustments of the estimated cash flows using the credit-adjusted risk-free interest rate that existed when the original liability was established. If the liability has multiple layers and the downward adjustment cannot be related to a specific prior period, a weighted-average of the credit-adjusted, risk-free interest rates that have been used to measure the liability should be used to discount the downward adjustment.

An enterprise should account for a change in the estimated cash flows as a change in estimate in accordance with paragraph 31 of APB 20.

Illustration 3–Subsequent Change to Cash Flow Estimates

As indicated in Illustration 1, the enterprise recognized a $194,879 liability for the fair value of an asset retirement obligation related to an offshore oil platform. After the initial obligation was recognized, the enterprise’s credit-adjusted risk-free interest rate declined by 0.5 percent to 8 percent. (The change in the credit-adjusted risk-free rate, by itself, would not result in an adjustment to the liability.) On December 31, 2004, the enterprise revised its estimate of labor costs to reflect an increase in the current market for labor. All other assumptions used in Illustration 1 remain the same.
Q38. How should an enterprise recognize a change in the timing of the estimated cash flows (e.g., the settlement date) without a change in the amount of cash flows?

A. Changes resulting from the timing of the settlement date should be recognized as increases or decreases in the asset retirement liability and the related asset retirement costs. If the change is related solely to timing, rather than an upward revision in the amount of undiscounted cash flows, the change in cash flow should be discounted using the credit-adjusted risk-free rate that existed when the original liability was recognized (i.e., the historical discount rate). (Refer to paragraphs 15 and B54 of the Statement.)

Q39. An enterprise recognizes an asset retirement liability at the inception of a ten-year lease for the obligation to remove leasehold improvements. After nine years, a change in the expected cash flows (e.g., extension of the lease) reduces the asset retirement liability. The asset retirement costs that were capitalized at the initial recognition of the liability have been substantially depreciated. If the reduction in the asset retirement liability exceeds the remaining unamortized asset retirement costs, how should the enterprise recognize the difference?

A. The enterprise should recognize any excess of the reduction in the liability over the remaining unamortized asset retirement costs as a reduction in depreciation expense for the period. For example, if the enterprise calculates a $10 reduction in the liability and the remaining unamortized asset retirement costs are $8, the enterprise should recognize $2 in operating income for the period.

Q40. Should an enterprise continue to recognize changes in an asset retirement liability for accretion expense and revisions to the original estimate of undiscounted cash flows after the asset is no longer in use?
A. Yes. Statement 143 requires an enterprise to recognize period-to-period changes in the liability for (1) the passage of time (accretion expense) and (2) revisions to the original estimate of the undiscounted cash flows. Accordingly, the enterprise should continue to recognize changes in the asset retirement obligation until it settles the obligation. Revisions to the original cash flow estimates for the liability generally are recognized as an adjustment to the carrying amount of the asset, which are depreciated over the remaining useful life of the asset. In this instance, the asset is no longer in use and, accordingly, any revisions in the liability that occur after the related asset has been taken out of service should be recognized as an adjustment to the basis of the asset and immediately recognized in income. (Refer to paragraphs 13 and 15 of the Statement.)
Capitalization of Interest Costs

The asset retirement costs that become a part of the carrying amount of a tangible asset do not qualify as expenditures for purposes of paragraph 16 of FASB Statement No. 34, *Capitalization of Interest Costs*. Thus, an enterprise should not include the asset retirement costs in its determination of the amount of interest that should be capitalized during asset construction or development. Further, the accretion expense that results from applying the interest-method approach prescribed by Statement 143 is not considered to be interest cost for the purpose of applying Statement 34.
Funding and Assurance Provisions

Some enterprises may obtain surety bonds, insurance policies, letters of credit, guarantees by other entities, and dedicated trust funds to satisfy an asset retirement obligation. These funding and assurance provisions do not eliminate the requirement to recognize the asset retirement obligation. For a previously recognized asset retirement obligation, changes in funding and assurance provisions have no effect on the initial measurement or accretion of that liability, but may affect the credit-adjusted risk-free interest rate used to discount any upward revisions from the original estimate. An enterprise should not present the funding or assurance provision as an offset to the asset retirement liability. Additionally, an enterprise should account for the costs of the funding or assurance provisions separately from the asset retirement obligation.
Oil and Gas Operations

Statement 143 will have a major impact on accounting for asset retirement obligations related to oil and gas properties. Statement 143 amends Statement 19 to require that dismantlement, restoration, and abandonment costs related to oil and gas properties be accounted for in accordance with Statement 143. The recognition of those costs are now subject to the requirements of Statement 143 and the accrual (liability) for those costs will no longer be presented as a contra-asset in accumulated depreciation, depletion, and amortization. In addition, the accretion of the asset retirement obligation will be presented as accretion expense, not in depreciation, depletion, and amortization.

The legal obligation for dismantlement, restoration, and abandonment costs generally will be incurred when a well is drilled or when a platform or other equipment is put in place. Enterprises with oil and gas operations outside the U.S. also must consider the specific asset retirement obligations in those foreign jurisdictions.

In applying impairment tests, Statement 143 indicates that estimated future cash flows related to the liability for asset retirement obligations should be excluded from undiscounted cash flows used to test the asset for recoverability and the discounted cash flows used to estimate the asset’s fair value. Capitalized asset retirement costs are included in the carrying amount of the related asset when tested for impairment. That guidance would apply to enterprises using the successful efforts method of accounting. However, the SEC has not yet amended the full cost ceiling test in Regulation S-X, Rule 4-10(c)(4) to reflect the effects of Statement 143 for enterprises that apply the full cost method of accounting. We understand that the SEC staff is considering this issue and has indicated that either of the following approaches may be acceptable pending further guidance from the SEC staff:

a. Exclude the cash flows related to the settlement of recorded asset retirement obligations from the full cost ceiling limitation; or

b. Include the cash flows related to the settlement of recorded asset retirement obligations as a reduction of the full cost ceiling limitation and reduce the carrying amount of the full cost pool by the recorded amount of asset retirement obligations.

Under the SEC’s full cost accounting rules, no gain or loss is recognized on sales of oil and gas properties unless the related adjustments to capitalized costs as a result of the sale would significantly alter the relationship between capitalized costs and proved reserves for the cost center. When the buyer assumes the related asset retirement obligation in a sale of oil and gas properties that would not significantly alter the relationship between capitalized costs and proved reserves for the cost center, the proceeds from the sale and the elimination of the asset retirement obligation would be recorded as adjustments to the capitalized costs of the full cost pool. In situations where gain or loss is recognized on the sale, the total capitalized costs within the cost center would first be allocated between the properties sold and the properties retained and the gain or loss would then be determined based on the proceeds received plus the asset retirement obligation assumed by the buyer less the allocated cost of the properties sold.
Gains or losses on settlements of asset retirement obligations should be recorded in income as required by Statement 143. Enterprises that apply the full cost method of accounting for oil and gas operations should not adjust capitalized costs of the full cost pool for gains or losses on settlement of asset retirement obligations because those gains and losses relate to settlement of the obligation, not sales of properties.

The SEC staff may be providing further guidance on the interaction between the full cost accounting rules and Statement 143 in the future.
Tax Effects

Recognition of asset retirement obligations and asset retirement costs will result in temporary differences between the book carrying amounts and the tax basis of the related assets and liabilities. Under FASB Statement No. 109, *Accounting for Income Taxes*, deferred tax assets and liabilities should be recognized for those temporary differences.

Statement 143 does not provide guidance on the application of Statement 109 to temporary differences related to asset retirement obligations. In many cases, the effect of recognizing a deferred tax asset for an asset retirement obligation and a deferred tax liability for a corresponding capitalized asset retirement cost will result in no net impact on tax expense upon initial recognition of the obligation. However, if a valuation allowance was needed for the related deferred tax asset after the initial adoption of the standard, tax expense would increase which would result in a net charge to income upon initial recognition of the obligation.

**Q41.** Does recognizing an asset retirement obligation result in an income tax consequence?

A. The recognition of an asset retirement obligation creates a deductible temporary difference for which a deferred tax asset should be recognized. Additionally, at the date that the liability is recognized, the related asset retirement costs are recognized as part of the cost basis of the asset. As a result, a taxable temporary difference is created for which a deferred tax liability should be recognized. At the initial recognition date, the deferred tax asset and the deferred tax liability are equal. However, the deferred tax asset and liability reverse in different periods. The deferred tax asset reverses when the obligation is settled. The deferred tax liability reverses as the asset is depreciated. As a result, an enterprise may need to record a valuation allowance on the deferred tax asset because it reverses in a different period than the liability. Although not addressed in Statement 143, we believe that if an enterprise requires a valuation allowance for the deferred tax asset when it recognizes the asset retirement obligation, it should recognize the valuation allowance as a charge to income tax expense in the period that the asset retirement obligation is initially recognized.
Cash paid to settle an asset retirement obligation should be classified in the statement of cash flows as an operating activity. (Refer to EITF Issue No. 02-6, *Classification in the Statement of Cash Flows of Payments Made to Settle an Asset Retirement Obligation within the Scope of FASB Statement No. 143.*)
Disclosures

Statement 143 requires an enterprise to disclose the following:

a. A general description of the asset retirement obligation and the associated long-lived asset;

b. The fair value of assets that are legally restricted for purposes of settling asset retirement liabilities; and

c. A reconciliation of the beginning and ending aggregate recorded amount of the asset retirement obligations showing separately the changes attributable to: (1) liabilities incurred in the current period, (2) liabilities settled in the current period, (3) accretion expense, and (4) revisions in estimated cash flows, whenever there is a significant change in one or more of those four components during the reporting period.

If an enterprise cannot make a reasonable estimate of the fair value of an asset retirement obligation, it should disclose that fact and the related reasons why it is unable to estimate the fair value.

SEC Regulation S-X, Article 10-01(a)(5), requires disclosure in an interim period of new accounting principles and practices, details in accounts that have changed significantly in amount or composition, and other significant changes that have occurred since the end of the most recently completed fiscal year. When a new standard is adopted in an interim period, the SEC staff has interpreted Article 10-01(a)(5) to mean that all disclosures (annual and interim to the extent not duplicative) prescribed by the standard should be included in the interim period financial statements, in addition to any transitional disclosures required by the standard.

Refer to additional discussion on transitional disclosures in a registration statement in the Effective Date and Transition section.
Effective Date and Transition

Statement 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. Earlier application is encouraged. An enterprise should adopt Statement 143 at the beginning of its fiscal year (i.e., January 1, 2003 for calendar-year enterprises). If an enterprise early-adopts Statement 143 during an interim period, it should restate all prior interim periods of that fiscal year. (See FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements.)

Upon initial application of Statement 143, an enterprise should recognize the following based on the requirements of the Statement:

a. A liability for any existing asset retirement obligations adjusted for cumulative accretion to the date of adoption;

b. An asset retirement cost capitalized as an increase to the carrying amount of the associated long-lived asset; and

c. Accumulated depreciation on the capitalized cost.

An enterprise should measure cumulative accretion and accumulated depreciation for the period from the date the liability and capitalized costs would have been recognized if the Statement were in effect when the enterprise incurred the liability to the date of adoption of the Statement and report that amount as part of the cumulative effect of a change in accounting principles, as described in paragraph 20 of APB 20. The amount reported as a cumulative-effect adjustment also would include the difference between the amounts, if any, recognized in the statement of financial position prior to the application of this Statement and the amount recognized at adoption of the Statement. The cumulative-effect adjustment also should include changes in the deferred tax assets, liabilities and related valuation allowance upon the adoption of the Statement. For the initial measurement of existing obligations, an enterprise should use current information, assumptions, and interest rates (i.e., as of the date of adoption, not the earlier date on which it incurred the asset retirement obligation).

Q42. If an enterprise recognized a liability for an asset retirement obligation before it adopted Statement 143, should the enterprise reverse the liability?

A. Statement 143 requires a cumulative effect adjustment measured as the difference between the amounts that an enterprise is required to recognize upon the adoption of the Statement and any amounts previously recognized in the statement of financial position. Accordingly, any previously recognized asset retirement liabilities (or contra-assets) should be reversed or adjusted to appropriate amounts as required by Statement 143 upon the adoption of the Statement and included in the cumulative effect adjustment. (Refer to paragraphs 26 and B86 of the Statement.)
Q43. Prior to the adoption of Statement No. 143, an enterprise acquired a tangible long-lived asset and assumed a related asset retirement obligation. Upon the acquisition of the asset, the enterprise recognized a liability for the asset retirement obligation and a corresponding increase to the cost basis of the asset. When the enterprise adopts Statement 143, should it identify and reverse asset retirement costs that were added to the cost basis of the asset (net of accumulated depreciation)?

A. As noted in the response to question 42, the amount to be reported as a cumulative-effect adjustment is the difference between the amounts, if any, recognized in the statement of financial position prior to the application of Statement 143 and the amount required to be recognized upon the adoption of the Statement. In this instance, the amounts recognized in the statement of financial position prior to Statement 143 include the asset retirement costs that were added to the cost basis of the asset. Accordingly, the asset retirement costs (net of accumulated depreciation) and the previously recognized asset retirement liability would be reversed (adjusted to amounts required under Statement 143) upon the adoption of Statement 143. (Refer to paragraphs 26 and B86 of the Statement.)

**Illustration 4 - Transition**

On January 1, 1993, an enterprise entered into an arrangement for a long-lived asset in which it agreed to perform asset retirement activities. The counterparty has the option to waive this requirement. Based on experience, the enterprise believed that it was not probable that it would be required to pay the retirement costs. Accordingly, the enterprise viewed the obligation as a contingency and, under the provisions of Statement 5, it did not record a liability for the obligation. The enterprise is a calendar-year company that will adopt Statement 143 on January 1, 2003. The following characteristics are relevant to the enterprise’s adoption of Statement 143:

- a. The long-lived asset has a useful life of 15 years;
- b. One hundred percent of the asset retirement obligation was incurred at acquisition and the obligation is expected to be settled at the end of the asset’s useful life;
- c. The enterprise uses straight-line depreciation;
- d. Estimated undiscounted cash flows of the asset retirement obligation liability based on information and assumptions at January 1, 2003 are $3 million, which reflects the enterprises probability assessments of settlement; and
- e. The enterprise’s credit-adjusted risk-free rate at January 1, 2003 is 8.5 percent.
As of January 1, 2003, the enterprise will record a liability for an asset retirement obligation of $1,995,000 ($3 million cash flows discounted for the remaining five years to the expected settlement date at the 8.5 percent credit-adjusted risk-free rate). The enterprise will record an increase of $882,000 to the carrying basis of the long-lived fixed asset ($3 million cash flows discounted for 15 years at the 8.5 percent credit-adjusted risk-free rate). The enterprise also will record a $588,000 increase to accumulated depreciation associated with the long-lived fixed asset (the increase in the carrying value of the fixed asset of $882,000 depreciated on a straight-line basis from the date of acquisition to the date of adoption). Finally, the enterprise will record the cumulative-effect of an accounting change of $1,701,000. (This example does not consider the potential tax effects of adopting Statement 143. A deferred tax asset, net of any required valuation allowance, would be recognized for the deductible temporary difference related to the asset retirement obligation and a deferred tax liability, or reduction to an existing deferred tax asset, would be recognized for the asset retirement cost, net of accumulated depreciation. The net impact of those adjustments to deferred tax assets and liabilities upon adoption also would be included in the cumulative effect adjustment.) (Refer to paragraphs D2 - D4 in the Statement.)

In summary, the enterprise will record the following on the adoption date of the Statement:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative-effect of an accounting change</td>
<td>$1,701,000</td>
</tr>
<tr>
<td>Long-lived fixed asset</td>
<td>882,000</td>
</tr>
<tr>
<td>Liability for an asset retirement obligation</td>
<td>$1,995,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>588,000</td>
</tr>
</tbody>
</table>

In addition to presenting the cumulative effect of an accounting change in the statement of operations, the enterprise should present income before extraordinary items and net income on a pro forma basis on the face of the statement of operations for all periods presented. The enterprise also should disclose on the face of the statement of operations the pro forma effect on earnings per share. Additionally, in the footnotes, the enterprise should disclose on a pro forma basis 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 Statement 143 had been applied during all periods. The pro forma amounts should be calculated using current information, assumptions and interest rates (i.e., as of the date of adoption).

Transitional Disclosures in a Registration Statement

As discussed in the Disclosures section of this guide, when a public company adopts Statement 143 in an interim period, it should include all disclosures that are required by the standard (annual and interim) in its interim financial statements, including the transitional disclosures (i.e., pro forma amounts). If annual financial statements for periods prior to adoption are included in a registration statement after the issuance of interim financial
statements that reflect the initial adoption of Statement 143, an enterprise should revise those annual financial statements for the period prior to adoption to include the transitional disclosures required by Statement 143 (if the amounts are material). For example, if an enterprise with a calendar year-end adopts Statement 143 on January 1, 2003, it should include all of the disclosures required by Statement 143 (annual and interim) in its interim financial statements for the quarter ended March 31, 2003. Additionally, if the enterprise files a registration statement after the March 31, 2003 interim financial statements have been issued, the enterprise should revise the December 31, 2002 annual financial statements in the registration statement to include the Statement 143 annual and transitional disclosures. Alternatively, if the enterprise incorporates its annual financial statements into the registration statement by reference, the enterprise may provide the required annual and transitional disclosures by filing revised annual financial statements in a Form 8-K that is incorporated into the registration statement by reference. The SEC staff has granted an accommodation whereby a company may avoid revising its previously issued annual financial statements (until the company would otherwise be required to reissue its financial statements for previous years, such as in its next Form 10-K) if (1) the company, together with their auditors, concludes that the financial statements are fairly presented, in all material respects, without the required disclosures and (2) the company includes the required disclosures in the registration statement or incorporates by reference a Form 10-Q or Form 8-K that includes the required disclosures.