School of
Accounting and Finance

Black Box Accounting: Discounting and disclosure practices of decommissioning liabilities

Giovanna Michelon (University of Bristol)

Mari Paananen (University of Gothenburg)

Thomas Schneider (Ryerson University)

bristol.ac.uk/
accounting-finance

Price of time:
Discounting in financial reporting

Joint webinar hosted by the EAA, EFRAG and ICAS

Characteristics of Decommissioning Liabilities (DLs)

- DLs (and environmental liabilities in general) refer to physical degradation of the environment, and the financial liability reported in the financial statement is a proxy for what it may take to remedy it
- Key question: *What happens when a firm can't or won't pay a decommissioning liability?*
- How is this addressed under IAS 37?

Aims of the research

1. determining the level of diversity in practice related to the choice of disclosing the discount rate and investigating country- and firm-level factors that might explain this diversity
2. identifying corporate disclosure and transparency practices that help stakeholders understand the ‘black box’ of decommissioning and other environmental liabilities
3. clarifying the nature of decommissioning and other environmental liabilities and pointing out the major implications of our findings for standard-setters, policymakers, preparers and auditors

Literature

- Accounting research on discount rates suggests that firms in certain circumstances use discount rates opportunistically (goodwill (Carlin and Finch,2010); pension provisions (Comprix and Muller, 2011))
- Diversity in disclosure practices related to environmental obligations is explained by societal, firm-and/or industry-specific, and individual-specific factors (Trotman and Bradley, 1981; Patten, 1991, 1995; Li and McConomy, 1999; Tilt and Symes, 1999; Patten and Trompeter, 2003; Cormier and Magnan, 2003; Lee and Hutchison, 2005)
- Environmental economics: discount rate on long-term liabilities key to how much weight is put on the welfare of future generations (Sterner and Persson, 2008; Gollier and Weitzman, 2010)

Research method

- Multi-method approach that combines an archival collection of disclosure practices for DLs and a set of interviews with stakeholders.
- International sample of publicly traded companies in pollution-prone industries (O&G, mining, and utilities) that reported under IFRS from 2005 to 2016
- Data were manually collected and coded from the notes to the financial statements with the support of textual analysis
- 27 interviewees from a unique cross-section of stakeholders (six preparers, seven auditors, five regulators and standard-setters, three users, four experts, and two representatives of civil society; from Canada, France, Italy, Spain, Sweden, the UK and the USA).
- Roundtable with a similar cross-section of stakeholders (two preparers, one auditor, two standard-setters/regulators, two experts, and one user), which facilitated face-to-face discourse among the participants.

Quantitative analyses

- Significant diversity in practice across industry sectors and countries.
  - O&G and mining sectors are more likely to adjust the discount rate than the utility sector
  - Mining sector tends to use a wider range of discount rates and to report higher rates than do the O&G and utilities sectors
  - Firms domiciled in Australia, Canada, South Africa and the UK tend to report higher discount rates than the rest of the sample.
- Determinants of disclosure of discount rates and/or adjusted discount rates vary across industry sectors.
  - Common driver across sectors is enforcement of regulations; firm-specific driver of disclosure is Big 4 auditors. Firm size also has a positive impact on the willingness to **disclose discount rates**, though only in the mining and utility sectors
  - Enforcement is negatively associated with the **level of the discount rate**, and country-level risk-free rates are positively associated with discount rate levels in the mining and utilities sectors
  - Canada, where O&G and mining companies are predominant, is a special case.

Disclosure practices

- Basic
  - succinct as providing only the overall timeline for the DLs (e.g., Pennon Group in 2009, Severn Trent in 2006)
- Extended
  - indicating specifically which assets (e.g., fields) will be decommissioned and in which years (e.g,. Aker Exploration in 2012); disclosing the discount rate indicating that each field was assigned a specific discount rate that considered inflation, rather than putting inflation in the estimation of future cash flows. May include sensitivity analysis to illustrate the impact of a change in the discount rate on the value of the DLs.
- Comprehensive
  - Besides the discount rate(s) used (i.e., the risk-free rate) and the horizon and timing of future cash flows, it discusses uncertainties, reconciled provision changes between beginning and ending balances with comparatives for the previous year and explained future cash outflows. (MOL, 2015).

Evidence from the interviews

- Choice of the discount rate
  - Aligned with findings of diversity in practice, with firms having the choice to use either a risk-free rate or a credit-adjusted rate when they discount DLs

So we view it as essentially an accounting policy choice, so most—I shouldn't say all, but most—of our really big clients factor their own credit risk into their provisions. (Auditor 8)

Certainly, I think the most technically correct answer is it's a risk-free discount rate. I'm sure you know this question went back to the IFRS Interpretations Committee *for guidance, and I would say the resulting rejection notice didn't actually help the situation at all, so rather than getting clarity, it just reinforced that there might be an element of judgement there.* (Auditor 6)

Company X11 uses basically the forty-year government bond, which could be all right, but others use the AA corporate index. There is a variety of measures that have been used, so which is the correct measure? (User 2)

Evidence from the interviews

- Disclosure practices
  - Key information need (not required): discount rate & undiscounted amount of the provision

  If you knew the undiscounted amount, you could see it is a primary-loaded estimate or a back-end-loaded estimate quickly by comparing it to the discounted estimate. (Preparer 10)

  The discount rates used and the methodology needs to be understood; otherwise, we have no understanding of how that final number was arrived at, let alone how it compares to any other companies. (NGO 1)

  - Canada an exception – legacy of old GAAP
  - Key information need (required, but lacking in practice): timing

  One of the biggest drivers of the decommissioning provision clearly is cost, but it's also timing. (Auditor 4a)

  None of them [companies] *says it costs x to dismantle it, and we will do phase one in this time period and phase two in that time period. And I don't know how to bundle [these things] together and discount it. They are not willing ever to disclose that; they usually say it's too commercially sensitive.* (Roundtable User 1)

Evidence from the interviews

- Conceptual aspects
  - All interviewees agreed that DLs are different from financial liabilities and that the general public is the ultimate owner of the liability in the event no clean-up occurs. In some jurisdictions, a seller may see DLs come back if a buyer defaults on them, another key factor that differentiates them from financial liabilities:

  If they sell an asset, they continue to track the buyer almost from a credit-worthiness perspective. They assess whether certain liabilities will come back to them because they know that, in the end, it could. I know some have legally come back to different companies. (Auditor 11)

  - No agreement on the use of a risk-free rate; some expressed intergenerational concerns; matching between DR and cash flows
  - Can DLs be fair-valued? → there may not be a willing buyer (what is being discounted in IAS 37 is an assumption based on the company actually engaging in the clean-up)

Conclusions

- Disclosure practices vary, the choice of discount rate choice is important, and this choice requires a great deal of deliberation. The question concerning whether to use risk-free rates or adjust discount rates for firm risk appears to an accounting policy choice
- Users need more disclosure— (1) discount rates used, (2) undiscounted amounts, and (3) timing
- Which discount rate? not perfectly clear, but there is consensus that these types of liabilities differ markedly from financial liabilities. However, disclosure of (1) to (3) above would allow users to make their own assumptions about the present value of DLs
- The key question for standard-setters is whether IAS 37 was written with the intention that the basis for calculating the discount rate should be an accounting choice or whether it is acceptable that such has turned out to be the case in practice.

University of BRISTOL

School of Accounting and Finance

Thank you

Giovanna.Michelon@bristol.ac.uk

bristol.ac.uk/accounting-finance