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Australia's carbon price
June 2011 financial reporting implications

The key message for directors and executives is the need for transparent disclosure, adequate risk management, and exploring the possible opportunities the carbon pricing mechanism may offer

June 2011 financial reporting implications

Impact on 30 June 2011 financial reports

The possibility of Australia implementing a carbon pricing mechanism has increased with the release of the Federal Government's proposals. The proposals are backed by the members of the 'Multi-Party Climate Change Committee' (MPCCC), which may imply, but not necessarily guarantee, the legislation may pass both Houses of Parliament in the months ahead.

An exposure draft of the legislation to enact the carbon pricing mechanism was released by the Federal Treasurer on 28 July 2011, and is open for comment until 22 August 2011 before being expected to be tabled in Parliament in early Spring.

Given these developments, the key question for companies is what the carbon pricing mechanism announcement means for the current June 2011 financial reporting cycle. In this alert, we set out some of the considerations of the carbon pricing mechanism for entities as they finalise their June reporting.

Background

On 10 July 2011, Prime Minister Julia Gillard announced the details of Australia's proposed carbon pricing mechanism. The Government expects the legislation to be passed by Parliament late in calendar 2011. From 1 July 2012, every tonne of carbon dioxide equivalent (CO_2-e) produced by approximately 500 of Australia's largest direct emitters will be priced at $23/tonne.

The carbon price will be fixed for three years from 2012 to 2015 (indexed annually by 2.5%). From 1 July 2015 a floating market based Emissions Trading Scheme (ETS) will commence whereby the Government sets the emissions level cap for Australia and the market determines the price of permits. The first five years of caps will be announced in the FY14 Budget. During the fixed-price period, the large emitters will be required to buy a fixed-price permit from the Government for every tonne of CO_2-e produced. Once the floating ETS commences the carbon price will be subject to a $15 floor price and a ceiling price of $20 above international carbon prices, with each rising annually at 4% and 5% respectively.

The announcement also included details of various industry and household compensation mechanisms:

- Compensation to low-to-middle income households via the tax and social security systems
- Significant compensation to industry including:
  - Emission-Intensive Trade-Exposed (EITE) industries via free permits
  - Steel sector special assistance of $300 million over five years to encourage innovation and efficiency in the sector. This is in addition to EITE assistance received by the steel industry
  - Coal sector compensation to assist the most emission-intensive coal mines (gassy coal mines) manage the transitional impact of the carbon pricing scheme
  - Manufacturing sector via grants and research and development incentives to improve energy efficiency and reduce emissions
  - Electricity sector compensation including payments to close 2000 megawatts of generation capacity and other compensation in the form of free permits, loans and loan guarantees.

A number of organisations will be significantly impacted by the proposed carbon pricing mechanism including potential compensation or assistance. Key sectors impacted include power generators, mining, oil and gas and heavy manufacturing. However, all entities might be expected to be impacted by the carbon pricing mechanism to some extent as its effects are felt more widely throughout the economy.

30 June 2011 financial reporting considerations

In light of the Government's announcement organisations should continue to monitor their continuous disclosure obligations as well as consider the potential impact including asset impairment testing and financial report disclosures as part of the June 2011 reporting season. The financial reporting considerations for June 2011 include:

- Impairment testing – The impact on June 2011 impairment testing will depend on whether the entity believes it can reasonably estimate the impact of the carbon pricing mechanism on the carrying amount of assets. Where an entity can reasonably estimate the impact of the carbon pricing mechanism based on management's expectations the current market assessment of the risks arising from the carbon pricing mechanism will need to be built into impairment testing, either directly (under a fair value model) or indirectly (by adjusting discount rates used in value in use models for risk premiums attached to the carbon pricing mechanism), in accordance with AASB 136 *Impairment of Assets.*

  Where an entity has taken the impact of the carbon pricing mechanism into account in its impairment testing the key assumptions used will need to be disclosed. If the entity has not taken the impact of the carbon pricing mechanism into account, because for example the entity is of the view that they cannot reasonably estimate the impact, then the reasons for this should be disclosed.

  Entities should also ensure that there is consistency in the assumptions applied in their financial reporting with respect to carbon pricing. For example, are the assumptions underlying asset impairment consistent with those used in assessing the recoverability of deferred tax assets.

- Disclosure of significant judgements and estimation uncertainties – for organisations where the carbon pricing mechanism may have a material impact, additional disclosures should be considered to comply with the requirements of AASB 101 *Presentation of Financial Statements* to disclose the significant judgements management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Such disclosures might include the manner in which the proposed carbon pricing mechanism has been taken into account (if at all) in the determination of recoverable amount and the likely impact on the measurement of provisions. Relevant extracts from the accounting standards are included on the back page.

  As much of the detail is still yet to be determined regarding exact amounts of compensation, it would be unlikely that an organisation would recognise specific balances for future compensation.

What is the impact?

If your organisation has not considered the impact of the carbon pricing mechanism in impairment calculations and is likely to be significantly impacted by these future events you should consider the following:

- *The potential impact for the organisation? Is your organisation in an industry that is considered to be heavily impacted by the carbon price, for example steel, power generation or mining?*
- *What has the organisation publicly released to the market already?*
- *What are others from your industry doing?*
- *What are investment analysts saying about the potential impact?*

- Future developments – in the Director's Report the directors must bring likely developments in the operations of the entity in future financial years and the expected results of those operations to the attention of the users of the annual report in accordance with Section 299(1) of the Corporations Act 2001. This may include the impacts of the carbon pricing mechanism. It should be noted that these disclosures are not required where they would result in unreasonable prejudice to the entity.

- Disclosures under ASX Principle 7 – listed entities are required to report how it manages its material business risks arising from the carbon pricing mechanism under the ASX Corporate Governance Principles and Recommendations.

- ASX continuous disclosure – the need to provide more general information to the market about the likely impacts of a carbon price on forecast results and operations should be considered. Carbon exposed industries might expect a certain amount of shareholder activism on this issue in the June 2011 reporting season.

Other considerations

Provisions and contingent liabilities – the effects of any enabling legislation will need to be taken into consideration in the measurement of existing provisions (particularly environmental provisions) once the legislation is 'virtually certain' of being enacted. New obligations may also arise under current and existing legislation around carbon emissions and carbon credits.

'Carbon pass-through' and price adjustment clauses in contracts – in light of the uncertainty around the introduction of a carbon pricing mechanism in Australia and passage of enabling legislation to implement it, many longer-dated agreements (particularly in the electricity sector) may have included clauses permitting an adjustment for the effects (if any) of an introduced carbon pricing mechanism. Many entities will be required to fair value these clauses, either because the contract itself is a derivative or the clause represents an embedded derivative.

Hedging programs – carbon pass-through and price adjustment clauses in hedging arrangements may be included in hedging arrangements. Management will be required to consider how they designate hedge relationships which make use of contracts that contain multiple risks. Even where the hedge relationship has been appropriately articulated, the carbon pass-through could potentially undermine hedge accounting or hedge effectiveness.

Carbon and energy reporting legislation

The National Greenhouse and Energy Reporting Act 2007 (NGER) requires companies that meet certain reporting thresholds to report their carbon emissions, energy consumption and energy production on an annual basis (30 June reporting period). This reporting underpins much of the data that will be used to administer compliance with the carbon pricing mechanism. There is a need for organisations to develop systems, business processes and governing structures to ensure that robust, reliable and timely non-financial data can be produced.

Accounting for permits

There is currently no formal guidance at the International or Australian levels on how to account for permits issued under emission trading schemes. IFRIC 3 *Emission Rights* was withdrawn in June 2005 by the IASB because of a lack of symmetry between the recognition and measurement of the permit asset and the emissions obligation. There are however various accounting treatments currently adopted in Australia. The 'fixed price' and government compensation elements of the proposed Australian scheme may also introduce additional consequences.

The IASB has recently issued a public consultation to seek broad public input on the strategic direction and overall balance of its future work programme, through its Request for *Views Agenda Consultation 2011*. The document includes discussion of the IASB's Emissions Trading Schemes project, which has been deferred by the IASB whilst it focuses on its higher priority projects (such as leases and revenue recognition), noting 'the IASB does not expect to reopen its discussions on this project until later in 2011'.

Given competing priorities and the timeframes involved in the IASB's due processes, it would be highly unlikely anything substantive could be expected before the proposed commencement of the carbon pricing mechanism, even if the IASB does resume discussions during 2011 and broadens its considerations to include the features (such as a fixed price period) of Australia's scheme. Furthermore, the most recent published AASB work plan (May 2011) indicates its intention to monitor the IASB's developments and continue liaison with constituents, which may also make it unlikely any guidance would be forthcoming from the AASB on the key accounting issues (and any such guidance might potentially conflict with later IASB guidance).

Both the immediate and longer term impacts of the proposed carbon pricing mechanism will be different for each entity. Significant judgement will be required and directors and executives should strive to ensure transparency and consistency in both their approach and disclosures.

Key contacts

To discuss the carbon pricing mechanism and how it may impact your business please contact:

Brad Pollock
Lead Partner – Sydney
Sustainability & Climate Change
bpollock@deloitte.com.au
Tel: +61 (0) 2 9322 7458

Peter Rupp
Partner – Perth
Sustainability & Climate Change
prupp@deloitte.com.au
Tel: +61 (0) 8 9365 7285

Jason Handel
Partner – Adelaide
Sustainability & Climate Change
jhandel@deloitte.com.au
Tel: +61 (0) 8 8407 7148

Paul Dobson
Director – Sydney & Melbourne
Sustainability & Climate Change
padobson@deloitte.com.au
Tel: +61 (0) 2 9322 5422

Steve Stavrou
Partner – Brisbane
Sustainability & Climate Change
sstavrou@deloitte.com.au
Tel: +61 (0) 7 3308 7258

Anna Crawford
Partner – Sydney
National Assurance & Advisory
Services Lead – Technical
acrawford@deloitte.com.au
Tel: +61 (0) 2 9322 7177

Set out below are relevant disclosures required by Australian Accounting Standards ***AASB 101: Presentation of Financial Statements and AASB 136: Impairment of Assets***. *Whilst some of the disclosures may not be mandatorily applicable in special purpose financial reports or those entities applying the 'Reduced Disclosure Requirements' (RDR), adequate disclosure should still be made to ensure the financial statements are presented fairly and give a true and fair view:*

Disclosure of significant judgements and estimation uncertainties

An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements (AASB 101.122)

An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:

a) Their nature
b) Their carrying amount as at the end of the reporting period (AASB 101.125).

An entity presents the disclosures in paragraph 125 in a manner that helps users of financial statements to understand the judgements that management makes about the future and about other sources of estimation uncertainty. The nature and extent of the information provided vary according to the nature of the assumption and other circumstances. Examples of the types of disclosures an entity makes are:

a) The nature of the assumption or other estimation uncertainty
b) The sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity
c) The expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected
d) An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved (AASB 101.129).

Disclosure of impairment testing assumptions

If the unit's (group of units') recoverable amount is based on value in use:

(i) A description of each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive
(ii) A description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information (AASB 136.134 (d)).

If the unit's (group of units') recoverable amount is based on fair value less costs to sell, the methodology used to determine fair value less costs to sell. If fair value less costs to sell is not determined using an observable market price for the unit (group of units), the following information shall also be disclosed:

(i) A description of each key assumption on which management has based its determination of fair value less costs to sell. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.
(ii) A description of management's approach to determining the value (or values) assigned to each key assumption, whether those values reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information (AASB 136.134 (e)).

If a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount:

(i) the amount by which the unit's (group of units') recoverable amount exceeds its carrying amount
(ii) value assigned to the key assumption
(iii) the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (group of units') recoverable amount to be equal to its carrying amount (AASB 136.134 (f)).

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