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Accounting alert

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Financial reporting implications of the Carbon Pollution Reduction Scheme

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The Federal Government (Government) released the **Carbon Pollution Reduction Scheme (CPRS) Legislation Exposure Draft** on 10 March 2009 (CPRS legislation). Entities may not have started assessment of the impacts of this legislation on their financial reporting and it is critical that entities do so in the lead up to the June reporting season.

It is the Government's intention that the proposed CPRS legislation will be introduced and heard in Parliament in May 2009, with the legislation passed into law in June 2009, ahead of the introduction of the CPRS legislation from 1 July 2010. However, this timeline is subject to some uncertainty given the Federal Opposition has announced that it will not support the legislation in its current form. Under the proposed CPRS legislation, organisations with facilities in specified sectors (stationary energy, transport etc) that emit more than 25,000 tonnes of CO^2-equivalent (CO^2-e) will be required to surrender an emissions permit for each tonne of CO^2-e produced in that year. The CPRS legislation will be based on a cap and trade scheme. The Government will set the volume of allowable emissions (the cap) and the market will determine the price of the permits based on supply and demand.

Regardless of whether the CPRS legislation is passed prior to 30 June 2009, entities should consider the actual or potential effects on current financial reporting. This may include the reassessment of impairment models and the potential recognition of additional provisions and other liabilities. In the event that the CPRS legislation is passed after year end, subsequent event type disclosures may also be required.

The following is a discussion of the more significant financial reporting implications of the proposed CPRS legislation that entities should be considering for their June 2009 financial statements.

Impairment testing

Is the CPRS legislation an impairment trigger?

The proposed or enacted CPRS legislation may in some cases be a so-called 'trigger' requiring an impairment test to be performed. Accounting standard AASB 136 *Impairment of Assets* requires an entity at each reporting date to consider whether an indication of impairment is present, and if so, requires the entity to perform an impairment test of the assets that could be impacted. One of the indicators noted in the standard is 'significant changes with an adverse effect on the entity that **have taken** place during the period, or **will take** place in the near future, in the technological, market, **economic or legal environment** in which the entity operates'.

Some may argue that where the legislation is still proposed there may be insufficient information regarding all the key elements of the CPRS to ascertain whether the pending change will have an adverse impact on the entity and hence it is unlikely to qualify as an impairment indicator. Others will argue that after the Rudd government signed up to the Kyoto protocol, the economic environment in Australia around climate control fundamentally changed and the question is not whether there will be a negative impact on business cash flows but rather what is the extent of the impact. Obviously if the legislation is passed by parliament prior to 30 June 2009 the debate around uncertainly of the impact is less relevant for the 30 June 2009 financial reporting period.

Despite uncertainties as to whether the impairment trigger is met prior to the legislation being passed, intangible assets with indefinite lives and goodwill are required to be tested annually for impairment, thereby reducing the importance of the trigger in cash generating units (CGU) that include goodwill or indefinite life intangibles.

How does the CPRS legislation impact the measurement of recoverable amount?

Once it is determined that an asset/CGU needs to be tested for impairment, the question then arises as to how the impacts of the CPRS legislation are to be built into an impairment model to determine the asset's/CGU's recoverable amount. Recoverable amount is defined in the standard as being the higher of the asset(s) 'fair value less costs to sell' and 'value in use'.

It is possible that the fair value (and value-in-use) of businesses will be impacted by the introduction of the CPRS legislation as the cash flows of the business could be negatively affected. Where a discounted cash flow model is used to determine recoverable amount, the standard requires the use of a discount rate that reflects the current market's assessment of the risks specific to the asset/CGU. The rate is estimated from the rate implicit in current market transactions for similar assets but is not adjusted for risks that have been reflected in the estimated cash flows. Until such time as the market knows the specific impact that the proposed CPRS legislation will have on an entity's cash flows, it is likely that the rate implicit in market transactions for similar assets will already have factored in a risk premium. Impairment models based off discounted cash flows will therefore need to ensure that there is consistency between the inclusion of negative cash flows as a result of the proposed CPRS legislation and the choice of discount rate.

What does management need to consider now?

Management needs to assess the impact of the proposed or enacted CPRS legislation to determine:

- whether it is a trigger of impairment for assets where there is no goodwill or indefinite life intangibles in the CGU
- whether the estimated impact of the proposed CPRS on the business' cash flows can be determined and built into the recoverable amount model
- whether current discount rates used in the recoverable amount model reflect the market's assessment of the impact of the proposed legislation on the business
- whether there is any duplication between amounts built into the cash flows and the discount rate in relation to the pending legislation.

Provisions and contingent liabilities

Does the CPRS legislation impact the recording of liabilities?

The introduction of the CPRS legislation may result in an increased cost of settling certain environmental and other provisions recognised by the entity – for example the provision for the rehabilitation of waste disposal sites. Consideration should also be given to whether any new obligations may arise under current and emerging legislation around emissions and carbon credits – for example considerable penalties can apply for non compliance with the *National Greenhouse and Energy Reporting Act 2007*.

How does the impact of CPRS legislation affect the measurement of provisions?

Accounting standard AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* requires the effect of possible new legislation to be taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. Evidence is required of both what the legislation will demand and of whether it is virtually certain to be enacted and implemented in due course.

What does management need to consider now?

Management needs to monitor the development of the CPRS legislation to ascertain when such objective evidence arises to ensure that provisions are appropriately measured.

Impact of carbon clauses on the valuation of derivatives and hedging

There is an increasing trend for generators and retailers of electricity with commercial contracts that extend past the proposed start date of the CPRS legislation to include clauses to take into account the potential impacts of the CPRS legislation. The lack of specificity around the price impact of the scheme means that most clauses to pass through the costs tend to be of a generic nature. Many entities will be required to fair value the impact of these clauses, either because the contract itself is a derivative or the clause represents an embedded derivative within the contract. Determining the appropriate valuation model and the collection of suitable data to use in the model can be complex and in many cases will be subjective.

Many of these contracts, particularly in the electricity sector, are being used in hedging arrangements. The unspecified adjustment to the 'fixed leg' of the contract to pass through the cost of the potential price impact of the scheme cannot be separated from the hedging contract when designating the hedge relationship. Management will need to reconsider how they designate hedge relationships which make use of contracts that now incorporate multiple risks. Even where the hedge relationship has been appropriately articulated, the pass through could potentially undermine hedge accounting or hedge effectiveness.

What does management need to consider now?

Management needs to consider:

- does the entity have any so called carbon clauses embedded in any of its contracts?
- how is the fair value of these clauses to be determined?
- does the inclusion of carbon clauses impact hedge effectiveness?

Disclosure of significant adjustments and estimation uncertainties

In industries where the proposed CPRS legislation may have a material impact, additional disclosures should be considered to comply with the requirements of accounting standard AASB 101 *Presentation of Financial Statements*. Until the legislation is passed by parliament, additional disclosures may be required to address the existence and potential impact of the uncertainties in estimates made by management. Such disclosures might include the manner in which the proposed CPRS legislation has been taken into account in the determination of recoverable amount and the likely impact on the measurement of provisions.

Accounting for emission rights

There is currently no formal guidance at 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 International Accounting Standards Board (IASB) because of a lack of symmetry between the recognition and measurement of the permit asset and the emissions obligation. The IASB and Australian Accounting Standards Board (AASB) have both added the accounting for emission rights to their respective agendas; however an exposure draft is not expected from the IASB until mid 2009. At the March 2009 meeting, the IASB agreed that free permits or allowances should be recognised as an asset and measured at fair value. However, the Board could not agree on how the credit arising from the recognition of the asset should be treated (as revenue or a performance obligation liability) – this will be debated at a future meeting.

Various accounting treatments are currently adopted in Australia for state based greenhouse gas abatement schemes already in place. These are discussed in the Deloitte publication *Australian Emissions Trading Scheme – Accounting for emission rights* available on www.deloitte.com.au. Potential treatments of emission rights under the proposed CPRS legislation are highlighted in the same publication.

Disclosures under ASX Principle 7

How an entity manages its material business risks arising from the CPRS legislation will need to be reported under Principle 7 (Recognise and Manage Risk) of the ASX Corporate Governance Council's revised Corporate Governance Principles and Recommendations. This legislation was applicable for the first time to the December 2008 financial reporters.

The ASX has flagged Principle 7 for its reviews in 2009 with special mention of sustainability and environmental risks (refer to the ASX Companies Update in December 2008 where the ASX reported that non-compliance for Principle 7 hovers in excess of 20 to 25 per cent compared to the other Principles, for which there is less than ten per cent noncompliance). This matter is discussed further in an article by Craig Mitchell (a partner in Deloitte Risk Services) titled *Material business risk* in the carbon-constrained economy – avoiding 'boilerplate' reporting against Principle 7, accessible on www.deloitte.com.au

Additional financial reporting issues may arise during the implementation of the CPRS legislation. Board Audit Committees should keep abreast of these and the passage of the legislation through parliament to ensure that the financial reporting impacts of the legislation are appropriately addressed in future financial reports.

National climate change reporting and assurance group contacts

If you would like more information or would like to discuss how the topics covered in this accounting alert affect your specific circumstances, please contact:

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