Energy and resources

The cost of carbon – a key risk for the energy and resources industry

Accounting for emissions trading remains on the IASB's agenda, with discussions on a new exposure draft expected to recommence in the second half of 2011.

What is the issue?

Governments around the globe are implementing policies and guidelines to reduce the greenhouse gas (GHG) emissions of their economies. Some jurisdictions, such as New Zealand and the European Union, have implemented an emissions trading scheme (ETS) to transition to a lower carbon economy.

An ETS is a mechanism to establish a market price for carbon through the means of emission permits. By limiting the number of permits available, governments reduce the amount of GHG emissions to a pre-determined level. Some countries, such as Australia, are proposing a carbon price mechanism which would initially have a fixed price before converting to a cap-and-trade ETS with a flexible price over time.

Currently there is no guidance on how to account for emissions trading schemes, yet many countries have already, or are in the process of implementing one. The International Financial Reporting Interpretations Committee (IFRIC) had previously released IFRIC 3 Emission rights but this was subsequently withdrawn by the International Accounting Standards Board (IASB) in June 2005. Accounting for emissions trading remains on the IASB's agenda with discussions on a new Exposure Draft expected to recommence in the second half of 2011.

For the companies operating in jurisdictions where emissions trading schemes have been, or are being put into place, new accounting policies will need to be developed and implemented. These companies will also need to keep abreast of the IASB and FASB developments in this area, especially those that may impact the accounting policies and treatments already applied.

Why is this issue significant for the resources sector?

The energy and resources industry is traditionally emissions intensive. Upstream mining and oil and gas operations are significant consumers of fossil fuels (coal, natural gas) and petroleum products (diesel, petrol, heavy fuel oil). Downstream operations (smelting, refining) are also heavy fossil fuel consumers but are also large consumers of electricity and may have additional process emissions captured under a carbon pricing regime.

Although it may be difficult to quantify the financial impact on individual entities, many companies within the resources sector will be significantly impacted by a price on carbon. Whilst this may be tempered by any transitional assistance provided by government to affected industries, a price on carbon remains a key risk for the resources sector.

What are the main accounting issues?

Entities operating in countries that have implemented an ETS, or are considering doing so, will need to consider the potential income statement and balance sheet impacts with reference to existing accounting standards and practices in the absence of additional guidance from the IASB.

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Item	Impacts	
	Balance Sheet	*Income Statement*
Emission permits (asset)		
• Purchase of permits	✓	✗
• Revaluation/amortisation	✓[1]	✓[1]
Obligations to surrender permits (liability)		
• Recognition of emission liability	✓	✓
• Revaluation of emission liability	✓[1]	✓[1]
Derivative financial instruments relating to emission permits (trading permits)	✓	✓
Carrying value of assets due to changes in cash flows	✓	✓
Tax treatment of an ETS	✓	✓

[1] Revaluation of emission permit assets and liabilities may not be required during a fixed price period.

Is your balance sheet at risk?

It is critical for entities in the industry to consider the cash flow impacts of an ETS prior to commencing an ETS. IAS 36 *Impairment of assets* requires an entity to assess, at each reporting date, whether there is any indication that an asset is impaired.

A change in the regulatory regime that will have a significant adverse effect on an entity and that will occur in the near future is considered an external impairment indicator under IAS 36. Therefore, assets within the scope of this standard will need to be tested for impairment upon the introduction of a carbon price if an entity is likely to be significantly impacted.

Changes to the carrying value of assets may also impact key financial ratios and covenants, in turn impacting access to and conditions of financing for some entities.

Estimating the cash flow impacts of price on carbon needs to take into consideration both the direct and indirect cash flow impacts of its introduction. This will involve assessing the entire supply chain, considering the potential cash flow/price implications at each stage and whether these impacts can be passed on to the end customer.

Direct impacts	Indirect impacts
• Purchase of permits • Tax treatment of those permits • Pricing impacts	• Increases in the cost of raw materials, fuels, machinery and equipment; and • Electricity price impacts

Assessing cash flow impacts will not only assist entities identify the potential balance sheet impacts, but also inform other key areas of focus for management such as:

- Feasibility studies
- Capital expenditure decisions
- Risk management and corporate governance
- Continuous disclosure requirements
- Supplier and customer contracts (carbon pass-through clauses)

Why act now?

Those entities operating within jurisdictions where an carbon price is currently proposed (for example, Australia) are encouraged to start to consider its accounting and financial management implications now. In particular:

- **Changes to relevant IT systems.** Systems to accurately capture and monitor GHG emissions take time to implement. Are an entity's reporting systems, processes and controls sufficient to provide adequate confidence over the completeness and accuracy of emissions data?
- **Changes to contracts.** Contracts with suppliers and customers are periodically negotiated – will there be an opportunity to revisit these again prior to a carbon pricing regime commencing?
- **Working capital implications.** Entities will need to understand the working capital impacts of the acquisition and retirement of any emissions trading permits then determine whether additional working capital is required.
- **Internal and external financial reporting.** Entities that are likely to be significantly affected by a carbon price should consider the disclosures they might need to make in their full year or half year report. This may include asset impairment disclosures, risk disclosures and other disclosures associated with significant judgements and estimates.

- **Corporate governance and risk management structures.** Carbon risk needs to be incorporated into the corporate risk management structure and strategies of the entity - first mover advantage can be secured through early adoption of a carbon strategy. Do the entities current management and board have sufficient knowledge to make carbon risk decisions?
- **Communication with stakeholders.** Regulators are taking a keener interest in the non financial disclosures of companies (ie sustainability reports), particularly in relation to the disclosure of non financial risks.

Where to from here?

Emissions trading schemes continue to be implemented across the globe; we encourage entities to keep abreast of the IASB and FASB developments in this area.