

Trouble-entry accounting*

Uncertainty in accounting for the EU Emissions Trading Scheme
and Certified Emission Reductions

Joint Survey undertaken by PricewaterhouseCoopers and IETA on the accounting approaches applied in practice



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“There is a widespread feeling that the EU ETS has made great progress but that the pace of change has not always been matched by its infrastructure. Carbon financial accounting is a case in point. The industry is plagued with diversity of accounting and no uniform approach seems to be in sight since the International Accounting Standards Board withdrew its accounting interpretation set out in IFRIC 3. The impact of accounting is increasingly important. Companies trading within the EU ETS perceive increasingly how allowances and carbon credits represent a significant asset. For example, between 2008 and 2012 some 2 billion allowances* will be issued.

The important question is how these are recorded for accounting purposes. The survey which IETA is doing in conjunction with PwC will be a step in the right direction of bringing more transparency and understanding on the real accounting issues within the EU ETS. On this basis IETA and PwC will be in a position to stimulate further debate and in turn action on a uniform standard”.

** Figures from Societe Generale.
Andrei Marcu, President and CEO, IETA*

Welcome

The emerging political consensus on climate change has pushed the green agenda from the debating chamber into the board room. Indeed, a raft of economic measures at the national and international level has ensured that both public and private companies have become increasingly alert to the financial consequences of climate change and the measures being employed to tackle it.

The European Union Emissions Trading Scheme (EU ETS) has emerged as one of the most significant measures to date to tackle climate change since its commencement on New Year's Day in January 2005. Overnight it created a pan-European market worth tens of billions of Euros and created new challenges and opportunities for those companies within scope of the scheme and the regulators overseeing it. By bringing the value of carbon dioxide emissions on to the balance sheet it also created a clear connection between emissions and corporate value.

As markets for carbon dioxide and other emissions emerge and develop in the EU and around the world, the need to communicate clearly and unambiguously to stakeholders about how company performance has been and is expected to be affected by such initiatives has become paramount.

A direct challenge to meeting this need for clear and effective accounting guidance and transparency was the withdrawal in June 2005 of the International Accounting Standards Board's (IASB) interpretation of how to account for the EU ETS (IFRIC 3)¹. This gave rise to a notable absence of guidance on carbon accounting at the international level to dictate a common and consistent approach between companies. Indeed, with alternative accounting treatments inevitably emerging, there is the risk that the comparability requirement of financial statements between entities as underpinned by the IASB Framework is undermined. This in turn poses clear risks to shareholder value and effective stakeholder decision making.

This risk is increased given the observed volatility in the market prices for the EU allowances in the past eighteen months which has led to volatility in company income statements and in the valuation of carbon assets and liabilities on balance sheets.

Whilst the EU ETS represents the most significant of the new carbon abatement measures introduced to meet Kyoto obligations, other measures such as the 'Clean Development Mechanism (CDM)' have also been developed. The CDM allows industrialised countries (also known as Annex 1 countries under the Kyoto protocol) to earn emissions reductions credits towards Kyoto targets through investment in qualifying and sustainable projects in fast growing countries (also known as host countries of the project). Firms and governments can invest in the CDM by purchasing the outputs of the CDM – 'Certified Emission Reductions' (CERs). Subject to certain limits the CERs will be convertible into EU Allowances to contribute to meeting carbon emissions obligations.

IFRIC 3 does not apply to the CERs scheme as it is not a 'cap and trade' scheme like the EU ETS, hence there has not been any clear guidance issued by the accounting standard setters specifically aimed at CERs. As for the accounting for EU ETS allowances, it is inevitable that a range of accounting approaches may emerge with regards to the treatment of CERs, both in terms of those that are received by the asset owners themselves and those that are purchased through bilateral trades in the market.

Given the growing importance and impact of carbon abatement measures on financial reporting, PricewaterhouseCoopers (PwC), in conjunction with the International Emissions Trading Association (IETA), have conducted a Europe-wide survey of the accounting approaches applied by major organisations which are significantly affected by the EU ETS. The survey focuses on the accounting for the EU ETS, but also covers the accounting for CERs, given the linkage to the EU ETS, and because there is a similar dearth of accounting guidance in this area.

The purpose of the survey and of this summary publication is to present a synopsis of the accounting approaches applied in practice and to understand the key themes and issues arising given the absence of definitive accounting guidance. At this stage this publication is not aimed to provide some accounting guidance nor any opinion on the accounting applied in practice. A more detailed publication has also been prepared and will soon be available on www.pwc.com/energy. This detailed publication analyses the results of the survey in depth and assesses the implications of the different accounting treatments adopted on the reporting of the organisation's financial performance and position as well as in the wider context of corporate reporting. The impending publication provides some guidance on how to account for the EU ETS and CERs schemes under IFRS, with reference to underlying standards.

Richard Gledhill, PricewaterhouseCoopers
Global Leader - Climate Change Services

Andrei Marcu, IETA
President and CEO

1. IFRIC 3 stands for the International Financial Reporting Interpretations Committee Interpretation 3 which provided guidance on the recognition of emissions rights, before its withdrawal in June 2005 by the International Accounting Standards Board (IASB).

Survey results

Accounting for the EU ETS



The withdrawal in June 2005 of the International Accounting Standards Board's (IASB) interpretation of how to account for the EU ETS (IFRIC 3), means there is no authoritative and uniform approach to the issue.

Contrary to commonly held views, IFRIC 3 complied fully with the current International Financial Reporting Standards (IFRS). The reason for its withdrawal was the often undesirable impact its adoption had on the income statement, introducing both volatility for those balances re-valued based on the prevailing market prices of allowances, and a mismatch between movements in the asset and liability as recognised through the income statement.

The withdrawal of IFRIC 3 did not however invalidate its application. Some companies across Europe have decided to continue to adopt it on the grounds that it remains compliant with existing IFRS. Other companies however have sought to adopt alternative approaches to address the shortcomings of IFRIC 3.

A summary of the responses to key accounting questions set out in our survey is presented on the following pages. The results reflect responses from both those with compliance obligations and broker-traders.

Only 14% of respondents adopt the IFRIC 3 approach and initially recognise granted allowances at fair value with the corresponding entry recognised as deferred income on the balance sheet.

65% of respondents recognise the granted allowances within intangible fixed assets.

58% of respondents recognise purchased allowances within intangible fixed assets, with the balance recognising them somewhere within current assets.

At what value are granted allowances initially recognised on the balance sheet?

Only 14% of respondents adopt the IFRIC 3 approach and initially recognise granted allowances at fair value with the corresponding entry recognised as deferred income on the balance sheet.

76% of respondents recognise the granted allowances at nil value. This is perhaps not surprising, as this approach can reduce the grossing up impact on the balance sheet and income statement that drew such criticism when IFRIC 3 was issued.

Where are granted allowances initially recognised on the balance sheet?

65% of respondents recognise the granted allowances within intangible fixed assets.

Under IAS 38, intangible assets are 'an identifiable non monetary asset without physical substance'. It appears the majority, 65% of all respondents, consider the granted allowances meet this definition. The balance of respondents recognise the granted allowances within inventory or apply alternative approaches which include recognition in 'other current assets' or not recognising them in the accounts at all.

Where are purchased allowances recorded on the balance sheet?

58% of respondents recognise purchased allowances within intangible fixed assets, with the balance recognising them somewhere within current assets.

The majority recognise purchased allowances as intangibles. The balance of respondents recognise the allowances within inventory (11%) or elsewhere on the balance sheet (31%).

Classifying the allowances as inventory might seem appropriate if the entity is holding them for sale 'in the ordinary course of business'. Financial institutions and traders that don't hold any physical assets and hence do not hold the allowances to meet any compliance obligations may look to apply this approach. Looking at the survey results, this isn't always the case however, with a mix of treatments being applied by both the companies with CO2 emitting assets and those trading purely on their own account.

Survey results

Accounting for the EU ETS

86% of respondents do not apply amortisation/depreciation to allowances recognised on the balance sheet.

Are granted/purchased allowances subsequently amortised/depreciated?

86% of respondents do not apply amortisation/depreciation to allowances recognised on the balance sheet.

The policy of amortising the allowances could imply the allowances are being consumed by the business over the period. It would appear the majority do not see this as representative of how the allowances are used and thus do not apply a policy of amortisation or depreciation. Instead, perhaps because the ETS allowances have a residual value, as evidenced by an actively traded market, respondents are not recognising the cost of allowances in the income statement until they are used to settle the obligation or are sold.

79% of respondents do not revalue the allowances subsequent to initial receipt / purchase.

Are granted/purchased allowances revalued subsequent to initial receipt/purchase?

79% of respondents do not revalue the allowances subsequent to initial receipt / purchase.

Of the 21% of respondents that revalue the allowances, all recognise the corresponding entry of the revaluation directly in the income statement rather than through reserves. It is interesting to note however that a number of those applying this policy recognise their allowances as intangibles, despite the standard on intangibles (IAS 38) specifically precluding revaluation movements from being recognised in the income statement.

50% of respondents who apply this approach release the deferred income to the balance sheet in line with the emissions produced in the period.

Where granted allowances are initially recorded at fair value and deferred income is recognised, how is the deferred income released to the income statement?

50% of respondents who apply this approach release the deferred income to the balance sheet in line with the emissions produced in the period.

As question 1 identified, only 14% of respondents adopt the IFRIC 3 approach of recognising granted allowances at fair value, with the corresponding entry to deferred income. Yet it is clear that even amongst this group, there is a lack of consensus as to how the deferred income is released, with some applying a simple straight-line basis for release, others applying a more systematic basis of using the production profile of the asset.

There is no clear consensus as to where in the income statement the deferred income should be released to.

Where granted allowances are recorded at fair value and deferred income is recognised, where in the income statement is the deferred income released to?

There is no clear consensus as to where in the income statement the deferred income should be released to.

Our survey showed that different treatments are being applied in relation to the release of deferred income: some record the release within revenue, some as a deduction against cost of sales and some as other income. The standard on accounting for government grants, IAS 20, states that a release should be against the cost that the grant was intended to compensate or as other income. At first sight, recognition within revenue would therefore appear unusual. Overall, it is clear that the different treatments mean the profit margins of similar companies may not be directly comparable.

A range of valuation treatments are applied in valuing the obligation associated with the production of emissions.

How is the obligation for emissions valued?

A range of valuation treatments are applied in valuing the obligation associated with the production of emissions.

The most common approach, applied by 47% of respondents, is to value the obligation (to the extent covered by allowances on hand) based on the carrying value of allowances already granted (which may be nil) and already purchased allowances. The balance of the obligation, if applicable, is then valued at the prevailing market price of allowances. Around 26% of respondents go one step further and also apply the cost of allowances in forward purchase contracts to value the equivalent element of the obligation. Some respondents, 16%, value the entire obligation at market price, akin to the IFRIC 3 approach, whilst the balance of 11% apply some other form of valuation treatment.

86% of respondents recognise the gain on disposal immediately in the income statement.

In the event granted allowances (that are recorded at nil value) are sold, how is the sale accounted for?

86% of respondents recognise the gain on disposal immediately in the income statement.

For those that sold granted allowances, the overwhelming majority, 86%, immediately recognise the sale as a credit to the income statement. Around 7% recognise the gain as deferred income which is released over the remainder of the compliance year. It is worth noting that whilst these alternative approaches might lead to the same result at year-end, where the financial year-end is not co-terminous with the compliance year-end, or where interim reporting is involved, the income statements under these two approaches would not be directly comparable.

Survey results

Accounting for the EU ETS

Most respondents (54%) recognise the sale of granted allowances as a deduction against cost of sales.

Following on from the previous question, which line item of the income statement is used to record the sale of granted allowances?

Most respondents (54%) recognise the sale of granted allowances as a deduction against cost of sales. This treatment perhaps reflects the judgement that the sale does not represent an inflow of economic benefits arising in the course of the ordinary activities of the entity, and hence does not meet the definition of revenue. Netting sales proceeds against cost of sales effectively represents a reduction in the cost of compliance with the EU ETS.

The balance of respondents recognise the sale of granted allowances within other operating income (23%), revenue (8%) or other lines in the income statement (15%). It is clear that a range of different approaches appear to be in place, raising the difficulty of comparing one company's financial performance against another's, gross margins in particular.

60% of respondents have engaged in forward purchase/ sale arrangements with regards to the EU ETS. Of these, more than half fair value the forward contracts.

Accounting for forward contracts to purchase and sell EU ETS allowances

60% of respondents have engaged in forward purchase / sale arrangements with regards to the EU ETS. Of these, more than half fair value the forward contracts.

Most respondents, 53%, deem the forward purchase / sale contracts to be within scope of IAS 39 and either fair value the contracts through the income statement (46%), or fair value through reserves under cash flow hedge accounting (7%). The balance of respondents largely account for the contracts on an accruals basis on the premise that the forward contracts were entered into to meet the company's own purchase, sales, usage requirements (referred to as 'own use') and hence exempt from the scope of IAS 39.

When asked whether the market for allowances is sufficiently active so as to provide reliable forward price curves that can be used to fair value the allowances and/or forward contracts, the overwhelming majority, 70%, considered this to be the case.

70% of respondents recognise the obligation based on pro-rating the forecast shortfall for the compliance year on a unit of production basis.

For interim reporting periods, in the event expected emissions will exceed allowances held, how is the obligation for emissions recognised over the compliance year?

70% of respondents recognise the obligation based on pro-rating the forecast shortfall for the compliance year on a unit of production basis.

In contrast to the majority that apply a unit of production basis, 15% of respondents only recognise the obligation once the emissions exceed the equivalent allowances held. This difference in approach could have implications for interim reporting and may lead to entities with a shortfall who do pro-rate the obligation recognising a liability and cost in the income statement in advance of those that only recognise the obligation once emissions exceed allowances on hand.

Conclusion

Accounting for the EU ETS

In summary, of the respondents where EU ETS is relevant, there is a wide variety of approaches being applied. In fact, it has been possible to identify as many as 15 distinct approaches being applied in practice. Ignoring differences in classification however, we have identified that there are 6 main approaches.

We have identified that there are six main approaches applied by respondents to the survey.

1. 5% of respondents apply the IFRIC 3 approach. Granted allowances are recognised at fair value when received, and the corresponding entry recognised in deferred income on the balance sheet. The obligation for emissions is recognised at market price. The allowances may or may not be revalued.
 - 2a. Recognise the granted allowances at nil value, with the obligation recognised at the carrying value for allowances already granted/purchased, with the balance valued at the prevailing market price. This is the most frequent approach being applied - 45% of respondents have adopted this policy.
 - 2b. This is a slight modification to the approach in 2a. Granted allowances are recognised at nil value with the obligation recognised at the carrying value for allowances already granted/purchased, then at the relevant contract price for allowances to be purchased under forward purchase contracts, with the balance valued at the prevailing market price. Around 15% of respondents apply this policy.
 - 3a. 10% of respondents recognise granted allowances at fair value with the obligation recognised at the carrying value for allowances already granted/purchased, with the balance valued at the prevailing market price.
 - 3b. This is a slight extension to 3a. 5% of respondents recognise granted allowances at fair value with the obligation recognised at the carrying value for allowances already granted/purchased, and at the relevant contract price for allowances to be purchased under forward purchase contracts, with the balance valued at the prevailing market price. As with 3a, the allowances may or may not be revalued.
 4. 5% of respondents recognise the granted allowances at nil value with the full obligation recognised at market value.
- 15% of respondents have used some other approach to recognising the granted allowances and the obligation.

It is clear from the above that the initial negative feedback generated by IFRIC 3 has translated into only a small minority of respondents applying the withdrawn interpretation as an accounting policy; presumably this is because of the volatility that this approach can create in the income statement. The other main approaches are a close variation of each other – 60% effectively recognise granted allowances at nil value (as allowed under the standard on government grants), albeit value the obligation in different ways. The most common approach for valuing the obligation is to value it based on the carrying value of allowances on hand. Any additional obligation is then valued at contracted prices and or market prices. This seems to suggest the obligation is valued based on the expected cost to the company of ultimately settling it. Again however, there are variations to the accounting policies in use.

Where the impact of the EU ETS is material to the organisation, applying such different policies can lead to very different impacts on the balance sheet and income statement. In our more detailed publication, soon to be available on www.pwc.com/energy, we provide some worked examples showing the different impacts on financial reporting for organisations that have identical backgrounds. The application of different policies also serves to demonstrate the importance of clear accounting policies in the financial statements.

Survey results

Accounting for CERs

As for the EU ETS, we asked various questions in our survey looking to understand the key accounting approaches used in practice in accounting for CERs. The results reflect responses from both developers and purchasers of CERs.

Consistent with the classification of ETS allowances, the results of the survey indicate that a broad range of classifications are used in practice.

There is no common approach for accounting for self generated CERs.

75% of respondents do not apply a policy of amortising/depreciating CERs.

How are purchased CERs initially recognised on the balance sheet?

Consistent with the classification of EU ETS allowances, the results of the survey indicate that a broad range of classifications are used in practice.

38% of respondents classify purchased CERs as intangible fixed assets and 38% classify them as inventory. 24% of respondents classify them in other areas of the balance sheet, such as 'other current assets' or as trading securities or short term financing assets.

How are 'self generated' CERs (ie granted in respect of qualifying assets held) accounted for on the balance sheet?

Again, there is no common approach for accounting for self generated CERs.

The results showed that 29% of respondents recognise the CERs as inventory upon generation, at an allocated cost of production. Around 13% of respondents record the CERs as intangible fixed assets, measured at fair value at the date of receipt. Interestingly, 29% of respondents adopt a policy of not recognising the self-generated CERs until they are sold or used in the business.

Are the self generated/purchased CERs amortised/ depreciated?

75% of respondents do not apply a policy of amortising/depreciating CERs.

As is consistent with the treatment of EU ETS allowances, most respondents do not amortise/ depreciate the CERs. This perhaps reflects the view that CERs have a residual value that approximates carrying value or that respondents expect to use the allowances within the current financial year.

Survey results

Accounting for CERs

62% of respondents do not revalue the CERs subsequent to initial receipt / purchase.

Are granted/purchased CERs revalued subsequent to initial receipt/purchase?

The survey showed that the majority of respondents, 62%, do not apply a policy of revaluing the CERs subsequent to initial receipt/purchase. The balance, 38% revalue the CERs through the income statement. Of these, interestingly a number classify the CERs as intangible assets yet still recognise revaluation movements through the income statement (as opposed to reserves which is the standard approach under IAS 38).

It is noteworthy that the majority of respondents, as is shown later in this publication, do not consider there to be an active market for CERs, which may further explain the decision by 62% of respondents not to apply a revaluation policy.

There is a lack of consensus as to how the self-generated CERs should be accounted for in the income statement.

How are 'self generated' CERs accounted for in the income statement?

There is a lack of consensus as to how the self-generated CERs should be accounted for in the income statement.

The results of the survey show a variety of responses. 67% of respondents immediately credit the income statement at the point of receipt of the CERs. Around 17% initially record the CERs as a government grant with the difference between fair value and production cost recognised as 'deferred income' on the balance sheet, which is released to the income statement when the CERs are used or sold. The balance of respondents credit the income statement with the full selling price when sold.

50% account for the forward contracts on an accruals basis.

How are the forward contracts to purchase/sell CERs accounted for?

50% account for the forward contracts on an accruals basis.

64% of respondents to the survey had participated in forward selling/purchasing agreements for CERs. The decision as to how to account for these varies. Around 50% account for the contracts on an accruals basis. On the whole this is because the respondents deem the forward contracts to be outside the scope of IAS 39 on the basis that they are exempt from the standard and they are entered into and continue to be for the entity's own purchase, sales or usage requirements. 37% deem the forward contracts to be within scope of IAS 39 and apply a policy of fair valuing the contracts through the income statement.



Do you consider there is a sufficiently active market in CERs to provide reliable forward price curves that can be used to fair value the CERs/ forward contracts?

Most respondents do not consider there to be a sufficiently active market for CERs so as to provide reliable forward price curves.

Whilst 37% of respondents fair value the forward purchase and sales contracts through the income statement, only 20% of respondents deem there to be a sufficiently active market for CERs to provide reliable price curves for valuation purposes. 53% consider the market not to be sufficiently active. In contrast to the market for EU ETS allowances, where 70% of respondents consider the market to be sufficiently active to provide reliable price curve data, the vast majority of those holding or trading CERs consider the market for CERs not to have reached a similar level of maturity and liquidity. This is perhaps not surprising as the various administrative steps allowing CERs to be fungible with EU ETS allowances have not yet been completed. In time, it would be expected that the price of CERs, at least in the secondary market, will shadow the market price of the more actively traded EU ETS allowances.

Conclusion

Accounting for CERs

In summary, of the respondents where accounting for CERs is relevant, it is possible to identify a number of different approaches being applied.

In summary, of the respondents where accounting for CERs is relevant, it is possible to identify a number of different approaches being applied.

Ignoring differences in classification, the survey results can be broken down into 2 approaches in accounting for purchased CERs. All initially recognise the purchased CERs at cost, but in terms of subsequent measurement:

1. 62% of respondents do not revalue the CERs subsequent to initial recognition.
2. 38% of respondents revalue the CERs subsequent to initial recognition. Of these, 20% recognise the CERs on the balance sheet within intangibles, 40% recognise the CERs within inventory and 40% within another heading in current assets.

Amongst those surveyed, most obtain CERs from the developer or in the secondary market. There were however 6 respondents to our survey that own qualifying assets and therefore need to account for 'self-generated' CERs. Of these, there are no clear accounting approaches emerging in practice for how to do this.

The approaches adopted by developers varied greatly. Whilst most respondents credit the income statement at the point of receipt of the CERs, there is a lack of clarity and consistency as to how they are recognised in the balance sheet - one recognises the self-generated CERs within inventory at an allocated cost of production, whilst other respondents do not recognise the CERs on the balance sheet until the CERs are used / sold.

Another of the respondents recognises the self-generated CERs as intangibles and as a government grant, measured as the difference between their fair value and their production cost, with the grant being released to the income statement when the CERs are sold or used.

Differences in EU ETS and CERs accounting policies between IFRS and other GAAPs used by respondents

Nearly half of all respondents report under accounting standards other than just IFRS, with most also reporting under US GAAP.

Our survey highlights that most reporters do not consider there to be many significant GAAP adjustments between IFRS and other standards, however the differences that were raised seemed to be different across different respondents. Those reporting under US GAAP tend to refer particularly to differences in valuation treatments of the forward contracts and allowances held on the balance sheet.

Challenges of financial reporting

“The withdrawal of IFRIC 3 meant that having developed processes to record transactions, our accounting approach to EU ETS had to be reworked and we had to spend more time deciding on an appropriate accounting treatment”.

“A large time commitment has been required to ensure that the accounting treatment which is used is appropriate”.

Source: Survey respondents.

In our survey we gave the opportunity for respondents to elaborate on the nature and extent of issues and challenges that arose when considering the accounting for EU ETS and CERs schemes.

The most significant issue, faced by 64% of respondents, related to the time spent in developing appropriate accounting policies as well as reacting to alternative approaches identified. Many organisations highlighted the time spent reviewing the treatments adopted by other entities, discussing the treatment with their auditors, and even some noted that they raised the issue with their trade bodies.

Another significant issue highlighted by 41% of respondents has been the concerns over the comparability of treatment and therefore of financial performance and financial position with other entities, particularly where the different accounting treatments affect the ‘bottom line’. Indeed, as demonstrated in the examples in the earlier section of this publication, the effect of different approaches, especially given the volatility in the market price of allowances, can be very significant. This makes sector and competitor comparisons and bench-marking more challenging and potentially misleading if the financial impact of the different treatments is not known by all stakeholders.

Whilst concerns have been expressed over consistency of treatments between groups, 18% of respondents expressed concern over the consistency of treatment within the same organisation. Concerns were also noted regarding differences in approaches adopted between IFRS and local GAAP accounting treatments, which can be time consuming and add further complexity to the reporting process.

Respondents also reported specific issues in connection with reporting to senior management within the organisation as well as the investment community. These issues were linked to the need to identify and justify different accounting treatments adopted by competitors and the need to reassess the suitability of the accounting policy following the withdrawal of IFRIC 3.

Challenges of financial reporting continued

“There now is a lack of consistency with the treatment applied by our main competitor’

“It is difficult as well to compare the business performance between the peers when accounting treatments are not clear or they vary so greatly”.

Source: Survey respondents.

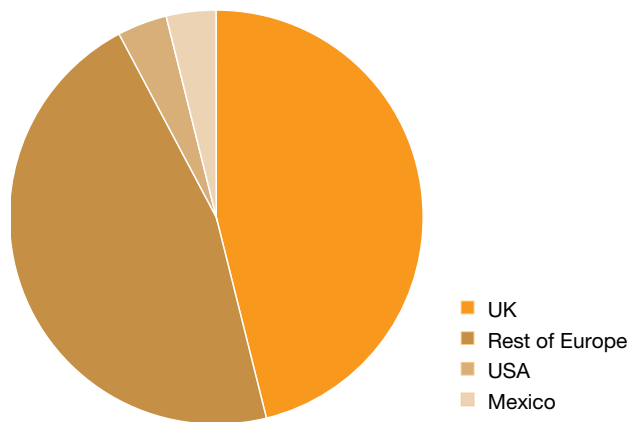
A number of respondents, 18%, also highlighted the challenges that the lack of guidance has created with regards to potential acquisitions and investment decisions. The decision as to how to account for both the EU ETS as well as CERs can have a significant impact upon company and transaction valuations as well as the structure of transactions. Respondents also highlighted the impact that different accounting treatments can have on taxation computations as well as the ability to understand the tax impact of transactions connected to the EU ETS or CERs schemes.

In summary, it would appear that the lack of clear guidance over the accounting for the EU ETS and for CERs has been both a source of frustration and a drain on resources for many of those organisations affected, in addition to creating a lack of clarity that has impacted internal decision making. It is beyond the remit of this publication to assess the impact this issue has had on external stakeholders, such as investors, analysts and other current and potential stakeholders, however it would surely be an interesting insight.

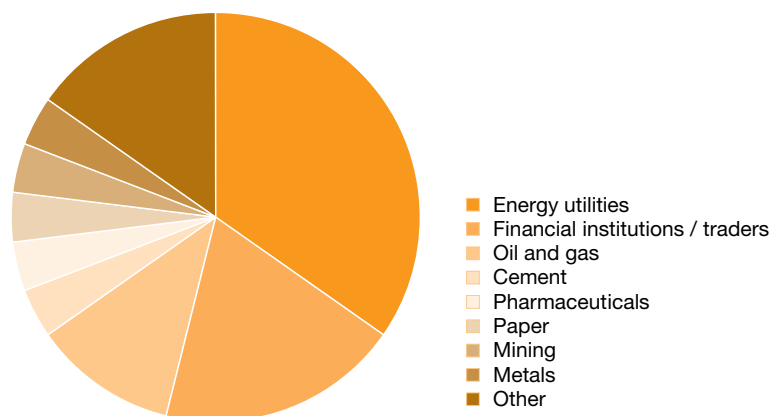
Who took part in the survey?

In initially conducting the survey, our primary focus was to target energy and utility companies, as it is those organisations that have been most heavily affected by Phase 1 of the EU ETS. As it turned out, the coverage of the survey gained momentum as interested parties shared it with their counterparts in different industries and geographical territories. In total, we received 26 responses to the survey, from a range of industries and geographic locations. Indeed as the analysis below shows, we received responses from a range of sectors, from metals and aggregates to paper and pharmaceuticals, and from countries as far a field as the United States and Mexico. Such a broad range of respondents highlights that the impact of carbon on corporate reporting is becoming increasingly widespread across different industry sectors and is now recognised as a global financial reporting issue.

Response by origin



Response by sector



Looking ahead



IFRS focuses on principles over prescription, but in all respects is based on a framework of understandability, relevance, reliability and comparability.

The withdrawal of IFRIC 3 opened up the opportunity for organisations affected by the EU ETS scheme to re-assess the accounting approaches on a principles basis. This has also been necessary for those involved in generating or trading in CERs. In many respects, this has demonstrated the challenges that preparers have of applying principles based accounting to such complex schemes, particularly where they have such pervasive impacts on the income statement and balance sheet. Of course, the impact of these schemes will affect different organisations to different degrees, and therefore preparers will apply judgement as to the extent of disclosure necessary to ensure the financial statements are consistent with the requirements of IFRS. As noted by some respondents however, different approaches being applied have inevitably raised some challenges in respect of comparability of financial reporting between different entities.

Looking forward, the IASB has stated that work on a project to address the underlying accounting for emissions trading schemes in a more comprehensive way than originally envisaged by the IFRIC is due to resume towards the end of 2007. This means that by the time clear guidance is issued, another round of financial reporting year-ends will have passed.

Until a set of firm rules are established, the emphasis must be on the preparers of financial statements, and their auditors, to ensure that the approaches adopted in respect of the accounting for the EU ETS and CERs schemes are compliant in all respects with IFRS. Stakeholders must also be provided with clear and sufficient disclosure. Such disclosure should define the accounting policy, and where it is considered material should also provide narrative to draw together the key balance sheet and income statement line items that are affected by each scheme so that stakeholders can understand their financial impact on the organisation. With climate change and carbon reporting moving further up the public and corporate agendas, the importance of transparency and comparability in this area has never been greater.

Contacts

In the event you wish to discuss the accounting issues raised in this publication, please contact Richard French or Jonathan Rose. Should you wish to discuss other matters in relation to carbon markets or transactions in general please contact Richard Gledhill.



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