

## **Staff paper – Possible Financial Reporting Implications of the Fixed Price Phase of the Proposed Carbon Price Mechanism**

### **Background**

1. In February 2011, the Australian Government made public its decision to introduce a carbon price mechanism comprising a fixed price phase and a flexible price phase. In July 2011, more details were released of the Government's Climate Change Plan followed by publication of the exposure draft of relevant legislation that is planned to be passed by parliament by the end of 2011.
2. According to the Government proposals, a fixed price phase would run from 1 July 2012 to 30 June 2015. From 1 July 2012, entities with emissions exceeding 25,000 tons of carbon dioxide equivalent (CO<sub>2</sub>-e) would be paying \$23 for each permit to emit a ton of CO<sub>2</sub>-e above that threshold, with the price to be increased annually by 2.5% until 2015. The flexible price phase involving an emissions trading scheme (ETS) would begin on 1 July 2015. The ETS is a cap and trade scheme, where the Government sets the cap on emissions and the market determines the price of permits. At the start of the flexible price phase, the carbon price would be subject to a transitional \$15 per ton of CO<sub>2</sub>-e floor and a ceiling of \$20 above the international price, respectively increasing by 4% and 5% annually.
3. There would be compensation to households through tax concessions and other mechanisms. There would also be significant compensation to entities within emissions-intensive trade-exposed industries and others through the issuance of free permits.
4. Under AASB Interpretation 1039 *Substantive Enactments of Major Tax Bills in Australia*, a Tax Bill would have accounting consequences only when the Bill has been enacted or substantively enacted prior to the end of the reporting period. Substantive enactment of a Tax Bill shall be taken to have occurred once the Tax Bill has been tabled in the Parliament and there is majority support for the passage of the Tax Bill through both Houses of Parliament. The enactment or substantive enactment of legislation relating to the carbon price mechanism would have accounting consequences for emitter entities and the Government, which are identified below.

### **Summary of the draft legislation**

5. The appendix to this paper contains a summary of provisions of the draft legislation on the Carbon Price Mechanism that may have accounting implications.

### **Possible accounting implications of the fixed price phase**

6. This paper sets out possible accounting implications of the fixed price phase of a carbon price mechanism. It is expected that the discussion of issues raised in this paper and other pertinent issues raised at the Board meeting will provide a basis for a staff paper intended to inform constituents about the accounting issues that may arise during the fixed price phase of a carbon price mechanism and possible accounting treatments in respect of those issues. At this stage, the discussion of the accounting implications of the flexible price phase can await the results of the IASB work on the subject, depending on the timing of that work. References to issues in a flexible price phase in this paper are with a view to clarifying conceptual issues involved so that reporting issues relating to a fixed price phase can be discussed.

7. In relation to accounting by emitter entities, this paper initially considers the nature of permits and different views about their classification as assets. It then discusses the liability arising from emissions and expense and asset accounts that may be affected in accruing that liability. A discussion of whether receipt of free permits embodies a present obligation and which approach would be more appropriate in recognising free permits would follow. Finally the paper looks at impairment considerations during and prior to the implementation of the fixed price phase and accounting for shortfall charges. The paper also briefly looks at the nature of carbon tax proceeds from a Government accounting perspective and various accounting issues involved in relation to a fixed price phase. The following identifies a list of topics/issues considered in the paper.
- (a) accounting by emitters;
    - (i) classification of permits – the nature of the permit and the type of asset;
    - (ii) recognising a liability for emissions;
    - (iii) recognition of free permits;
    - (iv) impairment considerations;
    - (v) accounting for shortfall charges;
    - (vi) onerous contracts and existing provisions; and
    - (vii) the impact on income tax; and
  - (b) accounting by Government;
    - (i) accounting for carbon tax proceeds;
    - (ii) accounting for purchased permits;
    - (iii) accounting for free permits;
    - (iv) accounting for permits – when issued; and
    - (v) accounting for permits – prior to issuance.

### **Accounting by emitters**

8. In the fixed price phase, a carbon tax does not appear to raise any new recognition, measurement, presentation or disclosure issues beyond those dealt with under current Australian Accounting Standards. This paper discusses issues that may arise regarding the application of Australian Accounting Standards under a carbon price mechanism during the fixed price phase.

### ***Classification of permits***

#### **Nature of permits**

9. Permits (carbon units), whether purchased or received freely as compensation in respect of a compliance year, satisfy the definition of an asset in the AASB Conceptual Framework. Permits are a resource controlled by the emitter entity as a result of a past event, that is the purchase or receipt of the permit, and provide future economic benefits. Control over permits results from the entity's ability to obtain economic benefits from the permits and to restrict the access of others to the permits, including restricting the access of the scheme regulator. In a fixed price phase, the future economic benefits embodied in a permit may flow to the entity by using the permit to settle emissions obligations or through conversion into cash by returning it to the Government for a refund.

### **The type of asset**

10. The following discusses a number of views as to the type of asset that permits represent:

#### ***Permits as intangible assets***

11. Some argue that permits are identifiable non-monetary assets without physical substance and, therefore, are intangible assets under AASB 138 *Intangible Assets*. These commentators note that permits are similar in nature to quotas and licenses and argue that there would need to be a rationale if you want to treat the permits differently from quotas or licenses, which are listed in AASB 138 as examples of intangible assets.

#### ***Permits as financial assets***

12. Some argue that permits are in the nature of financial assets on the basis that permits can be converted into cash, for example, by sale on the market in a flexible price phase or through return to the Government for a refund in the fixed price phase. This view regards the issuance of the permit as a contractual relationship between the Government and the emitter entity. These commentators argue that, while permits are purchased or are freely received pursuant to the requirements of law and an emissions scheme, the process of receiving the permits would involve registration, application and similar steps that in substance amounts to a contract between the emitter entity and the Government.
13. In contrast, others argue that the relationship between the emitter entity and the Government is statutory rather than contractual and therefore permits do not satisfy the definition of a financial asset.
14. In rejecting the classification of permits issued under an ETS as financial assets IFRIC<sup>1</sup> argued that permits:
- (a) are neither equity instruments nor contractual rights to receive cash or other financial assets and therefore do not meet the definition of a financial asset in IAS 32 *Financial Instruments: Disclosure and Presentation*;
  - (b) do not constitute a contract to buy or sell a non-financial item and therefore do not fall within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. Contracts to buy or sell non-financial items are within the scope of IAS 39 if they can be settled net in cash or another financial asset and are not entered into and held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements;
  - (c) are not a derivative because they do not have 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' and are not 'settled at a future date'. Therefore, they cannot be designated as a hedging instrument. (The fact that the permits may be instruments obtained by the entity free of charge does not mean that they have 'no initial net investment'.); and

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1 IFRIC 3 *Emission Rights* (issued 2004, withdrawn 2005)

- (d) being ready tradable does not make permits financial assets any more than, say, a readily tradable commodity.
15. Some counter the argument in paragraph 14(c) above by arguing that, while purchased permits do not satisfy the definition of a derivative, free permits may do so. These commentators argue that contrary to the IFRIC view that free permits may involve an initial net investment, the initial investment is generally nil. Moreover, they argue, even if expenses such as registration or similar charges are considered to constitute an initial net investment, the amount of these charges, compared with the full price of a permit, is small enough to satisfy the 'smaller' initial net investment condition specified in paragraph 9(b) of IAS 39.
16. If the relationship between the entity and Government is seen as being a contractual one (see paragraph 12), then in relation to an ETS (flexible price phase), it may be argued that free permits may be seen as financial derivatives because the underlying is the variable price in the market. However, this is not true about purchased permits in a flexible or fixed price phase since the initial investment is the underlying price at the time of the purchase. Furthermore, during the fixed price phase, free permits may be transferred to other entities but this is not expected to create an active market such as an over-the-counter market.

#### ***Permits as currency***

17. Some argue that permits are in the nature of currency as they can be used to extinguish an emissions obligation to the Government and can be exchanged for a national currency in the market in the case of a flexible price phase or through Government refund arrangements in the case of the fixed price phase. In other words, they can be considered a medium of exchange and store of value.
18. Others argue that the treatment of permits as currency may be relevant when permits are tradable in an active market and an exchange with international units is available under a scheme. Under the fixed price phase, permits are not tradable and international units cannot be used to extinguish emissions liabilities of Australian entities. As noted in paragraph 16 above, free permits may be transferred during the fixed price phase to other entities but this is not expected to constitute an active market.

#### ***Purchased permits as a prepayment***

19. Under the proposed legislation, purchased permits cannot be transferred or relinquished. Once a permit is purchased, it will automatically be deemed to have been surrendered and an entry is made in the registry by the scheme regulator showing the surrender. The automatic surrender of purchased permits during the fixed price phase may have accounting implications.
20. Some argue that the automatic surrender of purchased permits is tantamount to a prepayment of carbon tax. The proponents of this view regard this treatment to be a mirror image of the treatment by Government. The Government would treat the automatically surrendered purchased permits as initially a liability, which would be subsequently transferred to revenue based on the amount of actual emissions reported by the entity. Opponents of this view argue there is no technical reason for a symmetric treatment of automatically surrendered purchased permits by the entity. They argue that the entity should apply a uniform accounting policy for recognition and measurement of purchased and free permits.

21. Others argue that purchased permits should be treated the same way as free permits (whether as intangible assets, financial assets or currency). They note that the automatic surrender of purchased permits is an administrative procedure and should not affect the accounting for purchased permits. The entity continues to have control of the permit's economic benefits and would be able to use them to extinguish emissions obligations for that compliance year. The entity has also the choice of refraining from emitting and, therefore, can decide to obtain a refund for unused purchased permits (the proposed law, however, notes there will be safeguards in place to prevent liable entities from acquiring more purchased permits than they need to meet their liabilities). Thus rights and obligations associated with the purchased permits have not been affected by their automatic surrender.

### ***Liability for emissions***

22. Under AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* an entity should recognise a provision when:
- (a) it has a legal or constructive present obligation arising from a past (obligating) event;
  - (b) an outflow of resources embodying economic benefits to settle that obligation is probable; and
  - (c) the obligation can be estimated reliably.

The existence of a present obligation would mean the entity has no realistic alternative to settling that obligation.

23. The prevalent view appears to be that the obligating event is the production of emissions and not any other event at an earlier stage. This is when an outflow of resources is probable and the amount of that outflow is measured by the entity on the basis of the best estimate of expenditure required to settle the obligation at the year end. The entity would accrue a liability as it emits during the reporting period if a reliable year-to-date estimate of emissions can be made. The price at which the emission obligations are measured is the price of permits used in extinguishing that obligation. Thus in the flexible price phase the measurement would be made by reference to the market price of permits and in the fixed price phase the price at which the permits are purchased for the relevant compliance year the permits are used.

### **Capitalisation vs expensing**

24. In accruing a liability for emissions, asset and expense accounts would be affected depending on the circumstances of the case. When the taxation cost is incurred in producing an asset that is recognised in financial statements, capitalisation of the taxation to the cost of an asset would be considered. In all other circumstances, consideration should be given to recognising an expense. Accordingly:
- (a) if carbon tax is regarded as a cost that is incurred in bringing inventories of produced goods to their present location and condition (and not a cost relating to idle capacity), it would be included in the cost of inventory under AASB 102 *Inventories*. If the carbon tax is regarded as a cost in delivering a service (e.g. transport companies), the carbon tax would most likely be recognised as an operating expense;
  - (b) where the goods produced by an entity are used in own construction activity by that entity, the carbon tax would be capitalised under AASB 116 *Property, Plant and*

*Equipment* provided the cost is necessary to bring the item to the location and condition for it to be capable of operating as intended; and

- (c) it is unlikely that entities engaged in non-production activities would be emitters and subject to carbon tax. However, if such circumstances exist, the tax paid would most likely be treated as an expense.

### ***Recognition of free permits***

25. In the absence of an international accounting standard or guidance on ETSs, there are two possible approaches (the net approach and the gross approach) to recognising assets and liabilities when free permits are involved.

#### **Net approach vs gross approach**

26. Under the 'net' approach, a liability (asset) is recognised only when emissions obligations are in excess of (less than) the free permits. Some consider free permits as an increase in the emissions threshold beyond which the entity incurs a liability and any reduction in emissions below that threshold would result in an asset representing unused permits. Under this approach free permits are recorded at a nominal amount, which may be zero. Proponents of this approach regard it as being consistent with measurement of non-monetary government grants at a nominal amount under AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance*.
27. Proponents of the 'gross' approach argue that the carbon price mechanism gives rise to an asset for the permits held and a separate liability for emissions obligations. They argue that permits and emissions obligations exist independently of each other, conform to definitions of assets and liabilities under the AASB Conceptual Framework and there is no legal right of set off between them. This approach is also seen as being less complex and providing useful information to users.

#### **Determining the credit entry for free permits**

28. There are three views about the recognition of free permits and whether it results in an obligation arising from their receipt.

##### ***View A***

29. Proponents of this view argue that there is no obligation in relation to receipt of free permits. They argue that the only obligation that arises from the emission scheme is when the entity emits.

##### ***View B***

30. Under this view, the emitter entity receiving free permits is unconditionally obligated to comply with scheme requirements and cannot avoid those obligations through future actions. Whether it chooses to emit or not, the entity, must transfer resources by surrendering the permits or apply resources to reduce emissions. That is, the obligation exists independently of these future events.
31. Opponents disagree with the conclusion that the obligation to refrain from emitting exist independently of future events. They argue that the outcome is within the control of the entity and that future events have a role in determining the obligating event.

***View C***

32. Some draw a parallel with the situation where obligations relating to the receipt of government grants involve conditions. They note that, under AASB 141 *Agriculture*, when a government grant requires an entity not to engage in specified agricultural activity, an entity would recognise the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met. Proponents of this view argue that, by analogy, an entity receiving free permits has agreed to a condition. The condition is to refrain from emitting in order to keep the permits or return them if the entity fails to do so. If the entity satisfies the condition, it would be able to keep the permits and if not, it has to return them to the Government<sup>2</sup>
33. Some commentators argue that the treatment of free permits as conditional government grants would mean that only when emissions go beyond that represented by free permits, an expense and a liability arising from emissions is recognised. The entity would need to purchase permits to extinguish that liability. This approach is not consistent with the 'gross' approach since a liability is only recognised when emissions go beyond that represented by free permits.
34. Others argue that once an emissions scheme is in place, eligible entities are subject to the requirements of that scheme. That means emitting would no longer be a costless exercise and the entity should incur expenditure if it emits beyond a certain threshold set by regulation. These commentators note that free permits are compensation for certain industries to help them cope with the expenditures that would arise from the introduction of the emission scheme and to help them maintain competitiveness with overseas entities in the short term. Gradual reduction in number of free permits would give these entities time to take measures to reduce their emissions. Accordingly, the entity should accrue a liability as it emits and it should do that irrespective of whether it would extinguish the emissions obligations through purchased or free permits.
35. Others argue that there is a difference between the conditional grant to refrain from engaging in an agricultural activity and a conditional grant to refrain from emitting. In the former if an entity does not refrain, it has to return the grant. The entity incurs expenses by engaging in relevant economic activity to earn revenue. In the case of free permits, if an entity does not refrain, it can still benefit from free permits by using them to extinguish part of its emission obligation. If an entity refrains from emitting, the entity will receive an economic benefit in the form of inflow of cash by selling the permits on the market or to the Government.

***Recognising free permits - possible approaches in the Australian context******For-profit entities – AASB 120 approach***

36. For-profit-entities would be subject to AASB 120. Free permits would be treated as non-monetary government grants and there would be a choice of recognising them at a nominal amount (which could be zero) or at fair value for both the asset and government grant. When recognised at fair value, the government grant would be recognised as deferred income and taken to profit and loss on a systematic basis over the period the entity incurs emission costs.

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2 This view is based on the tentative decision made by the IASB at its September 2010 meeting about whether the receipt of free permits leads to an obligation for the entity.

37. IFRIC 3 prohibited recognition of free permits at a nominal amount on the grounds that it would not accord with a faithful representation of the resources controlled by the entity, because purchased permits are indistinguishable from free permits.

*For profit entities – AASB 141 approach*

38. Accounting for free permits using the AASB 141 approach has the attraction that it may help avoiding the recognition of free permits granted at a nominal amount which is allowed under AASB 120. Under AASB 141, free permits would be valued at fair value which would be the market price in an ETS and the fixed price of a purchased permit for a compliance year in the fixed price phase.
39. If AASB 141 is to be used for recognition and measurement of free permits under a fixed price phase, then identification of a condition or conditions would be necessary to allow the recognition of granted free permits as a conditional liability. The IASB discussed the issue of recognizing free permits as a conditional liability in its September 2010 meeting and tentatively concluded that there is a condition and that free permits embody a conditional liability. It was noted that the condition is ‘to refrain from emitting in order to keep the permits or return them to the regulator if you fail to refrain from emitting’.

*Not-for-profit entities – AASB 1004 approach*

40. Not for-profit (NFP) entities are not allowed to apply AASB 120 or AASB 141 in accounting for government grants. Accordingly, to account for free permits, NFP entities would apply AASB 1004 *Contributions*, which would require permits to be recognised at fair value with a credit to income<sup>3</sup>. Under the fixed price phase, the fair value would be determined by reference to the fixed price of the permit for the relevant compliance year.
41. Some argue that the application of AASB 1004 is only relevant if the grant is received in a non-exchange transaction. They argue that receipt free permits embody a conditional liability, then AASB 1004 would not apply. Arguably, this would help ensure consistent recognition and measurement of free permits across all sectors.

***Impairment considerations***

42. If there is a prospect that cash outflows arising from the payment of carbon tax would result in the carrying amounts of any assets of the entity not being recoverable, the entity would have to apply AASB 136 *Impairment of Assets*. Impaired assets would be written down to the recoverable amount, with a charge against profit.
43. Many NFP entities base impairment on depreciated replacement cost (DRC), because service potential rather than cash flow is most relevant for these entities. For these entities, value in use is the DRC of an asset where the entity would, if deprived of the asset replace its remaining future economic benefits. As long as service potential is not affected, there is no impairment concern from introducing a carbon tax in relation to these entities. However, it is possible that carbon tax may reduce the demand for the asset in the market thus reducing its DRC which would be a trigger for assessing impairment of the non-cash flow asset.

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3 Note work is currently being undertaken on a project to replace AASB 1004.

**Purchased permits**

44. Under the proposed legislation a purchased permit that is issued for a fixed charge during the fixed price phase is not transferable. However, the surrender of surplus permits relating to a fixed charge year will result in a refund. This happens on settlement, that is when the actual emissions are known and the number of surplus purchased permits can be ascertained. The refund price is the price charged in respect of the relevant compliance year. Because of automatic electronic surrender of purchased permits at the time of purchase, one might conclude that purchased permits are unlikely to be impaired during the fixed price phase, since on settlement the entity will receive the full price of surplus purchased permits.

**Free permits**

45. Free permits issued during the fixed price phase are transferable to other entities and can be returned to the Government for a refund. Therefore, free permits are not automatically surrendered on the day they are received. These different arrangements for free permits are intended to enable entities to sell some free permits to compensate for payment of additional electricity and similar costs.
46. Under the draft legislation, the refund price for permits takes account of the time value of money. Accordingly a free permit returned at the end of a compliance year is expected to be refunded fully; that is at the price of a purchased permit for that compliance year. Free permits would either be surrendered to extinguish an emissions obligation, or transferred to another entity or returned for a refund. Free permits on hand beyond a certain date after the end of the compliance year would be cancelled by Government. The cancellation of free permits relating to a compliance year may have impairment implications for emitter entities. There may also be measurement implications for free permits that are regarded as surplus on hand at an interim reporting date.

**Impairment considerations prior to implementation of a carbon pricing mechanism**

47. The above considerations relate to impairment of assets when the carbon price mechanism is operational. In relation to accounts issued before substantive enactment of related legislation, the effect on asset impairment testing will depend on the management's assessment of the impact of a future carbon tax on recoverability of the assets' carrying amounts. It may be necessary to disclose information about the potential impact of a carbon tax on asset values and relevant assumptions made and significant uncertainties under paragraph 125 of AASB 101 *Presentation of Financial Statements*. Clearly, there would be further accounting consequences once the legislation is enacted or substantively enacted.

**Accounting for shortfall charges**

48. Shortfall charges become due when the required number of permits commensurate to quantities emitted are not surrendered by the due dates. In the fixed price phase, the procedure for surrender of permits is progressive and slightly different from that applied in a flexible price phase. In the fixed price phase, permits representing about 75% of emissions for the compliance year should be surrendered by 15 June in the compliance year. If the required number of permits are not surrendered by this date, a provisional shortfall charge would apply for which a provision should be made under AASB 137.
49. The entity may have a final shortfall charge on settlement (which would be before 1 February of the financial year after the compliance year). If the shortfall charge is not paid, it attracts

interest and a provision would need to be made for the shortfall charge and accrued interest as the circumstance may require.

***Onerous contracts and existing provisions***

50. A carbon tax may lead to onerous contracts under AASB 137 if the contracts do not provide for increased costs, such as pass-through clauses. Existing provisions may also be affected by the carbon tax legislation.

***Impact on income tax***

51. Carbon tax would be a deductible expense for income tax purposes. Under AASB 112 *Income Taxes*, there could be deferred tax consequences to the extent assets and liabilities relating to the permits/carbon tax are recognised.

## Accounting by Government

### *Accounting for carbon tax proceeds*

#### System of National Accounts

52. The System of National Accounts (SNA)<sup>4</sup>, Chapter 17 – cross cutting and other special issues notes:

*“17.363 Governments are increasingly turning to the issuing of emission permits as a means of controlling total emissions. These permits do not involve the use of a natural asset (there is no value placed on the atmosphere so it cannot be considered to be an economic asset) and are therefore classified as taxes even though the permitted “activity” is one of creating an externality. It is inherent in the concept that the permits will be tradeable and that there will be an active market in them. The permits therefore constitute assets and should be valued at the market price for which they can be sold.”*

Based on the above, the carbon tax is a tax under the SNA and the following is intended to address how it might be accounted for by the Government under Australian Accounting Standards.

#### Australian Accounting Standards

53. AASB 1004 *Contributions* paragraphs 30 and 31 state:

*“30 Control over assets acquired from involuntary non-reciprocal transfers, such as rates, taxes and fines, is obtained when the underlying transaction or other event giving rise to control of the future economic benefits occurs. For example, taxes are recognised when the underlying transaction or event that gives rise to the GGS’s or whole of government’s right to collect the tax occurs and can be measured reliably. In some cases an inability to reliably measure taxes when the underlying transactions or events occur means that they may need to be recognised at a later time. In most cases, taxes will be recognised in the reporting period in which the tax assessments are due to be issued or during which the tax collections are received. For this reason, the disclosure of policies adopted for recognising taxes will enhance the understandability and comparability of information relating to them.*

*Taxes Collected by Government Departments*

*31 It is unlikely that taxes, for example, income tax, will qualify as income of the agency responsible for their collection. This is because the agency responsible for collecting taxes does not normally control the future economic benefits embodied in tax collections (see AASB 1050). Taxes are recognised when the definition of, and recognition criteria for, income is met. Accordingly, taxes which are controlled by the tax collection agency and which satisfy the recognition criteria for income specified in paragraph 12 of this Standard*

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4 SNA (2008), <http://unstats.un.org/unsd/nationalaccount/docs/SNA2008.pdf>

*qualify for recognition as income in the reporting period during which control is obtained. This means that taxes are treated in the same manner as described in paragraph 30.”*

Based on the above paragraphs, carbon tax proceeds would be considered to be non-income tax revenue. The Government would accrue a carbon tax receivable as emissions are made by emitters in a similar way to accruing income tax revenue.

### ***Accounting for purchased permits – as a liability***

54. Purchased permits would be automatically surrendered during the fixed price phase. They would be treated as a prepayment of carbon tax by the Government until settlement occurs in respect of the related compliance year. Free permits, however, are not automatically surrendered. Entities may transfer them to other entities or return them for a refund to help with additional electricity and similar costs arising from introduction of a carbon price mechanism. Accordingly, the Government recognises a liability until the permits are returned (to either extinguish the entity’s debt or for a refund). At that point income would be recognised.

### ***Accounting for free permits – as an expense***

55. Free permits may be allocated to certain entities during the fixed price and the flexible price phases. Issuance of free permits by the Government would be treated the same way as subsidies (i.e. as an expense). The Government would consider accruing compensation payable at the year end.

### ***Accounting for permits – when issued***

56. In relation to accounting by Government as issuer of permits there are contrasting views. Some argue that the issuance of permits, in itself, does not have an accounting consequence since permits are seen as an accountability mechanism by the Government. They note the dollar effect of a carbon price mechanism would begin when entities incur obligations for emissions. At that time, and based on a reliable measurement of that obligation, the Government would accrue revenue from carbon tax.
57. Others note that the issuance of permits and receipt of cash would lead to a financial liability for the government until the permits are surrendered by the emitter and the surplus permits are returned for refund. As emissions take place, consistent with the tax liability recognised by the emitter, the government would recognise tax income. This view regards the issuance of the permit as a contractual relationship between the government and the emitter entity.
58. Others argue that the relationship is statutory rather than contractual and regard free permits issued by government as statutory payables.

### ***Accounting for permits – prior to issuance***

59. Some note that emitters and their annual emissions are known to the Government as they report under the *National Greenhouse and Energy Reporting Act 2007*. Therefore, they argue, the Government should recognise an intangible asset for the ‘right’ to tax emitters measured on the basis of permits it expects to issue in respect of a compliance year. They

note the case is analogous to the right to sell 3G spectrum licenses, where previous sales or auctions might provide a reliable measurement of the value of unissued licenses, enabling the Government to treat them as an asset.

60. Others argue that permits would be internally generated and cannot be recognised as an intangible asset by the Government.
61. Arguably, the issues surrounding the existence and sale of rights by the Government involve conceptual complexities that are expected to be addressed in the long run, and in a broader context than the 'right' to tax emitters.

## Staff View

### *Accounting by emitter entities*

62. In relation to the accounting by emitter entities, staff are of the view that during the fixed price phase:
  - (a) a gross approach for the recognition of assets and liabilities arising from the carbon tax mechanism should be appropriate;
  - (b) permits, whether purchased or received free of charge, should be recognised as intangible assets under AASB 138, using a cost-impairment model;
  - (c) a liability for emissions should be recognised as the entity emits under AASB 137, with relevant expenses either capitalised or taken to profit or loss based on the circumstances;
  - (d) free permits should be recognised using a government grant approach. For consistency with recognising purchased permits, an approach not leading to the recognition of free permits at a nominal amount is preferable; and
  - (e) a provision for a shortfall charge should be recognised under AASB 137 based on the occurrence of obligating events relating to provisional and final shortfalls.

### *Accounting by Government*

63. In relation to the accounting by Government, staff are of the view that during the fixed price phase:
  - (a) carbon tax proceeds should be considered as non-income tax revenue;
  - (b) the surrender of purchased permits by emitter entities should be regarded as a carbon tax received in advance by the Government which is taken to revenue progressively as a reliable measurement of emissions by the emitter entity becomes available; and
  - (c) free permits issued by the Government should remain a liability until surrender in the extinguishment of debt or for a refund, or cancellation if no surrender takes place by the date stipulated in the regulations.

### **Questions for the Board**

- (a) **Does the Board agree with the staff view above in relation to accounting for assets and liabilities arising from the carbon price mechanism in the fixed price phase?**
- (b) **If not, what modifications would be necessary to arrive at an appropriate application of Australian Accounting Standards in the fixed price phase?**

## **Appendix: Summary of Provisions of the Draft Legislation on Carbon Price Mechanism that may have Accounting Implications**

### **General**

#### ***A carbon unit is a property right***

1. A carbon unit issued by the Regulator is personal property and, subject to the requirements of the carbon price mechanism, transmissible by assignment (that is, as a result of some form of agreement to transfer the units to another person), by will (that is, as part of a deceased person's estate) and by other forms of transfer permitted by law.

#### ***The emissions number***

2. The total quantity of emissions for which the entity is responsible is known as the 'emissions number'. A person's emissions number for an eligible financial year is defined to be the sum of the person's provisional emissions numbers (PENs) for the eligible financial year. PENs represent the emissions from each facility, or embodied emissions from total supplies of natural gas, for which a person is responsible for an eligible financial year.

#### ***Issuance of carbon units***

3. The Regulator may issue a carbon unit with a particular vintage year at any time before the end of 1 February following the vintage year.

#### ***Assessment of a liable entity's liability for emissions***

4. Under the mechanism, liable entities will assess their own emissions numbers and report them to the Regulator under the *National Greenhouse and Energy Reporting Act 2007*. This is designed to remove any unnecessary duplication for liable entities, by retaining the existing emissions reporting framework with appropriate amendments.

#### ***Eligible emissions units in the fixed charge period***

Note: An 'eligible emissions unit' is a carbon unit, an eligible international emissions unit, or an eligible Australian carbon credit unit (ACCU) issued under the Carbon Farming Initiative (CFI).

5. In the fixed charge period the Regulator will issue free carbon units to liable entities. These free carbon units will be transferable but must be surrendered in the eligible financial year that corresponds to their vintage year.
6. An unlimited number of carbon units whose vintage year is a fixed charge year will be available to liable entities at a fixed charge. These units will not be able to be banked for use in future years (i.e. they cannot be used for surrender in any year after the vintage year).
7. Those carbon units that are issued free of charge can only be surrendered in relation to the eligible financial year corresponding to their vintage year and, if not surrendered, will be cancelled at the end of 1 February of the next financial year.
8. 'Borrowing' will not be allowed during the fixed charge years. That is, a liable entity cannot surrender a carbon unit of a later vintage to meet its obligations for a fixed charge year.

9. Free carbon units may be allocated to liable entities. These free carbon units can only be surrendered for their vintage year. They will be cancelled by the Regulator if they have not been surrendered at the end of 1 February of the eligible financial year after their vintage year. They may, on request, be bought-back and cancelled by the Regulator during the period between 1 September of their vintage year and 1 February of the financial year following from their vintage year at the fixed charge for the relevant year discounted by a factor in the regulations. They are cancelled if they are relinquished, rather than transferred to the Commonwealth relinquished units account. (This account is the Commonwealth Registry account designated as the Commonwealth relinquished units account and is used for units relinquished during the flexible charge years.)
10. Some liable entities that receive free carbon units with fixed charge vintage years may not want to surrender these units against a liability for that vintage year. To ensure that persons who are issued with carbon units can sell these units when they do not wish to surrender them, the mechanism allows the Regulator to 'buy-back' these units. The person may wish to sell these units to receive cash, which can then be used to offset the increase in monetary costs it faces due to its use of electricity or natural gas and its components as a feedstock, rather than hold these units for surrender.
11. The buy-back facility will be open from 1 September of the vintage year of the carbon units until 1 February of the next calendar year. It lets persons receive the corresponding level of the fixed charge for each free carbon unit he or she wants to sell back to the Regulator, discounted by a factor specified in the regulations.
12. For buy-backs occurring in the period before 15 June of the relevant eligible financial year, the Government proposes that the price paid by the Regulator for these carbon units will be discounted to 15 June of the relevant eligible financial year by the latest Reserve Bank of Australia index of the BBB corporate bond rate, so that the buy-back price reflects the present market value of the carbon unit. From 15 June onwards the price paid will be equal to the fixed charge carbon units of that vintage.
13. If the Regulator receives a request to buy-back free carbon units, it will cancel the units and remove the entries for those units from the Registry account of the liable entity that held them and, and will pay the buy-back amount to the person.
14. There will be a standing appropriation for the Regulator for the purpose of making payments for the buyback of free carbon units.
15. If an entity ceases conducting an emissions-intensive trade-exposed activity, it will be required to relinquish carbon units that had been issued to it for production that did not occur.

*Fixed charge carbon units*

16. The Regulator will also issue carbon units at a fixed charge that will be available to liable entities to discharge their emissions obligations under the mechanism. These carbon units will be automatically surrendered for the eligible financial year corresponding to their vintage year.
17. Carbon units issued for a fixed charge cannot be transferred to another entity.
18. Carbon units issued for a fixed charge are automatically surrendered for the eligible financial year corresponding to their vintage year. They cannot be banked.
19. In the fixed charge period, a carbon unit cannot be surrendered unless it has a vintage year of that financial year.

20. The fixed charge per carbon unit is:
  - \$23.00 in 2012-13;
  - \$24.15 in 2013-14; and
  - \$25.40 in 2014-15.
21. In fixed charge years, a liable entity may apply to the Regulator for an allocation of fixed charge carbon units for a particular compliance year from 1 April in that compliance year until 15 June. These carbon units are for a liable entity to meet their liability to surrender carbon units by 15 June of the eligible financial year.
22. A liable entity may also access fixed charge units from the date its emissions number is published until 1 February of the following year (the final surrender date). These carbon units are for a liable entity to meet its liability to surrender carbon units by 15 June of the eligible financial year.
23. In fixed charge years, if a liable entity surrender units greater than the amount of its total emissions liability for the relevant year, then these units cannot be carried forward to count towards any liability for following years. The Regulator will pay a cash refund to the liable entity for the value of the excess surrendered units. The Consolidated Revenue Fund is appropriated for the purpose of making these refunds.

*Use of ACCUs and international units*

24. In the fixed charge period, a liable entity may use eligible ACCUs up to an amount equal to five per cent of its total emissions liability.
25. Eligible international emissions units cannot be surrendered during the fixed charge period.

**Eligible emissions units in the flexible charge period**

26. In the flexible charge years, the Regulator will issue carbon units equal to the pollution cap. These units will be transferable between Registry accounts. The Regulator will continue to issue some carbon units free of charge for industry assistance during the first three years of flexible charge phase and these will be able to be used in the eligible financial year that corresponds to the vintage year as well as any later years. The remaining carbon units will be issued through auctions conducted by the Regulator.
27. Carbon units that have a vintage year that is a flexible charge year do not have a 'use by' date. They can be used for surrender in their vintage year and any year after that ('banking').. There is also limited capacity to surrender carbon units which are of the following vintage year ('borrowing').
28. A person may transfer carbon units during the flexible charge period.

*Use of ACCUs and international units*

29. In the flexible charge period, a liable entity may also surrender eligible ACCUs with no limit and surrender eligible international emissions units to discharge up to 50 per cent of their total emissions obligations.

*Shortfall charge*

30. In a fixed charge year, most liable entities must meet their liability for emissions progressively:

- (a) a provisional surrender must be made before the end of 15 June of the eligible financial year to avoid a provisional unit shortfall charge. This covers 75 per cent of estimated emissions for the year ('interim emission number'); and
  - (b) a final surrender must be made before the end of 1 February of the following financial year to avoid a final unit shortfall charge, at which the time the liable entity discharges its liability for the full year.
- 31. If the liable entity surrenders no units, or an insufficient number of units, it will be liable to pay a unit shortfall charge.
  - 32. The level of the unit shortfall charges for fixed charge years is set at 130 per cent of the fixed charge for the eligible financial year. The level of the unit shortfall charges for flexible charge years is set at 200 per cent of the benchmark average auction charge for the previous financial year, subject to regulations setting a different rate.
  - 33. In the fixed charge period, most liable entities must surrender sufficient units by 15 June to account for 75 per cent of the entity's estimated emissions for the current financial year ('interim emission number'). If a liable entity does not meet its progressive surrender obligation, it will have a provisional unit shortfall and be required to pay unit shortfall charge. The provisional unit shortfall is equal to the total interim emissions numbers minus the number of eligible emissions units surrendered for the liable entity.
  - 34. During the fixed charge period, there will also be a unit shortfall calculated in accordance with the obligation to surrender permits by 1 February following the compliance year. This is known as the 'final unit shortfall'
  - 35. The progressive surrender obligation during the fixed charge period is similar to the approach taken to payments for some forms of taxation, such as company tax and the GST.

#### *Relinquishment of units*

- 36. A person may relinquish carbon units under the mechanism. for example, planned production ceases during a year, or where a court has ordered relinquishment following conviction under specified provisions of the Criminal Code relating to fraudulent conduct, including those relating to false or misleading statements in information given to the Regulator .
- 37. Where units with a vintage year which is a fixed charge year are relinquished, the units are cancelled.
- 38. For a carbon unit for a flexible charge year, if it is relinquished, then it is transferred to the Commonwealth relinquished units account and property is transferred to the Commonwealth.