



To:	AASB members	Date:	30 August 2011
From:	Ahmad Hamidi	Agenda Item:	21.1
Subject:	Financial Reporting Implications of a Carbon Tax	File:	

Action

1. Conduct a preliminary discussion of possible accounting implications of a future carbon tax in the light of information available about the proposed Australian carbon price mechanism to date, with a view to providing staff with directions on issues requiring further research.

Background

2. In February 2011, the Australian Government made public its decision to introduce a carbon price scheme comprising a fixed price phase and a flexible price phase. In July, 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.
3. 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 (CO₂-e) would be paying \$23 for each permit to emit a ton of CO₂-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 CO₂-e floor and a ceiling of \$20 above the international price, respectively increasing by 4% and 5% annually.
4. There would be compensation to households through tax concessions and other mechanisms. There would also be significant compensation to emission-intensive trade-exposed industries and others through the issuance of free permits.
5. The following tentative considerations focus on the accounting implications of the fixed price phase. It is expected that the discussion of issues raised in this memorandum and other pertinent issues raised at the meeting would provide a basis for a staff article intended to inform constituents about the accounting issues that may arise during the fixed price phase of a carbon tax 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.

Accounting implications

6. 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 Bill has been tabled in the Parliament and there is majority support for the passage of the Bill through both Houses of Parliament.

By analogy, the enactment or substantive enactment of legislation relating to the carbon price mechanism would have accounting consequences for emitter entities and the Government.

Accounting by Emitters

7. 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.

Liability for emissions

8. The entity would accrue tax payable as emission takes place during the reporting period under AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* 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.
9. Under the proposed legislation, in the context of 30 June year ends, about 75% of emission obligations should be extinguished by 15 June each year and the remaining 25% would be extinguished after the year end within a pre-set time constraint when a reliable measure of emissions during the compliance year would be available. Thus, if an entity receives free permits in instalments (say, 75% early in the compliance year and the remaining in the next year with a different vintage), then it uses the first instalment to extinguish 75% of its emission obligations which are measured at the price of the permits received during the compliance year. The remaining liability at the year end would be measured at the price of permits with the next year's vintage, to reflect the best estimate of the expenditure required to settle the obligation at the balance sheet date. An entity would also be liable to pay a unit shortfall charge involving penalty if it does not surrender, by a certain date, the required number of permits (carbon units).

Capitalisation/ expensing

10. When the taxation cost is incurred in producing an asset that is recognised in financial statements, capitalisation 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*. Where the carbon tax is regarded as a cost in delivering a service (eg transport companies), it would be expected to 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.
 - (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 be treated as an expense.

Accounting for permits

11. Permits that are purchased, or received freely as compensation, in respect of a compliance year would be regarded as an asset until they are surrendered to extinguish a liability arising from emissions.
12. Under the proposed legislation a permit that is issued for a fixed price is not transferable. However, the surrender of surplus permits in a fixed price year will result in a refund payment for the surplus permits. Permits not used in the respective compliance year cannot be used to extinguish the tax liability of another year. If such permits are not returned for refund and there is the risk of their expiry, impairment considerations would be relevant.
13. Purchased permits with future vintage years acquired during the fixed phase would be regarded as assets until they are surrendered to extinguish any tax liability in respect of those years.

The nature of the asset

14. Permits are identifiable non-monetary assets without physical substance and, therefore, could be regarded as intangible assets under AASB 138 *Intangible Assets*. Whether they are purchased or received free of charge, they would be measured at the official fixed price for relevant vintage year because they are not transferable, and the entity can only redeem the purchase price of the surplus permits by returning them to the Government. Consistency of measurement would help ensure faithful representation of the resources controlled by the entity in cases involving free permits.
15. Measurement of permits and emission obligations at the official fixed price is not expected to lead to a 'mismatch' in the balance sheet or profit and loss statement.

Gross or net

16. Proponents of the 'gross' approach argue that the carbon tax mechanism gives rise to an asset for the permits held and a separate liability for emission obligations. Those arguing for the 'net' approach note that a liability (asset) is recognised only when emission obligations are in excess of (less than) the permits.
17. Staff note that the accounting for permits and emission obligations does not give rise to a net asset or liability. This is because, permits and emission obligations exist independently, conform to definitions of assets and liabilities under the *AASB Framework* and there is no right of set off between them.

Compensation

18. Free permits are provided to certain entities such as those operating in emission-intensive trade-exposed industries to compensate for the cost of carbon tax.
19. In accounting for free permits not-for-profit entities would apply AASB 1004 *Contributions*, which would require permits to be recognised at fair value with a credit to income. Under the fixed price phase, the fair value would be determined by reference to the official price.
20. For-profit-entities would be subject to AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance*. 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. However, recognition at a nominal amount would not accord with a faithful representation of the resources controlled by the entity, because purchased permits are indistinguishable from free permits. Accordingly, the government grant should be set up as deferred income and recognised in the profit and loss statement on a systematic basis over the period the entity incurs emission costs.

Impairment

21. 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 recoverable amount, with a charge against profits.
22. Many not-for-profit 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 DRC of an asset where the entity would, if deprived of the asset replace its remaining future economic benefits. So 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.
23. In relation to June 2011 financial statements, 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*.

Onerous contracts

24. 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

25. Existing provisions such as site remediation provisions may be affected by the carbon tax legislation.

Impact on income tax

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

Accounting by Government

27. The System of National Accounts (SNA)¹, 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.”

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

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 GAAP.

Australian Accounting Standards

28. AASB 1004 *Contributions*² 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 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.”

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

Compensation

30. Compensation by government would be treated the same way as subsidies. It is an expense for government. The government would consider accruing compensation payable at the year end.

Accounting for permits

When issued

31. 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 tax 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.

² Note work is currently being undertaken on a project to replace AASB 1004.

32. 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 revenue. Under this view, permits are regarded as a financial asset by the emitter. This view regards the issuance of the permit as a contractual relationship between the government and the emitter entity.
33. Others argue that the relationship is statutory rather than contractual and regard permits issued by government and purchased or freely received by the entity as statutory payables and receivables respectively.

Prior to issuance

34. 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.
35. Others argue that permits are internally generated and cannot be recognised as an intangible asset by the Government.
36. Staff note the issues surrounding the existence and sale of rights by governments involve conceptual complexities that are expected to be resolved in the long run, and in a broader context than the 'right' to tax emitters.