



Business Case Briefing

GHG Risk Reporting and Balance Sheet Emissions Accounting: Discussion Points

The following is a summary of discussion points from a Climate Northeast conference call on April 26, 2005.

PART A: Implications of Sarbanes-Oxley for Reporting of Climate-Related Information

- The Sarbanes-Oxley Act (SOA) of 2002 does not directly address environmental issues, nor does it alter existing environmental disclosure rules. It enhances penalties, personal liability and organizational controls related to disclosure of information broadly.
- SOA raised the stakes for corporate financial reporting and, consequently, altered both the context and the interpretation of existing disclosure rules, including rules that are specific to environmental liabilities. SOA is pushing corporations to review existing disclosure rules and to follow them in a more conservative manner.
- Basic disclosure rules require companies to disclose any "material" *financial* and *non-financial* information. Materiality should not be defined by a rule of thumb, e.g., a percentage of revenue. It is a judgment call based on what a "reasonable shareholder would consider important."
- Companies must also disclose "contingent liabilities." These are liabilities based on events that have not yet occurred. Disclosure must consider both *probability* and *magnitude* of the event.
- Existing SEC rules for disclosure of environmental liabilities can be found under SEC Regulation S-K (17 CFR 229), particularly Items 101, 103 and 303. Regulation S-K requires disclosure of material information as well as specified items, including potential impacts based on regulatory trends and uncertainties, for example, GHG regulations. For climate liabilities, this often boils down to disclosure in the MD&A section (Management Discussion & Analysis) under "known trends" (see Regulation S-K, Item 303). Compliance upgrades to facilities can be booked like regular capital expenses under Property, Plant & Equipment, provided the upgrades are known.
- The Statement of Financial Accounting Standards (FAS) No. 5 provides further guidance on dealing with "loss contingencies," considering both probability and ability to estimate.

If the loss contingency is material and is....

	Reasonably Estimable	Not Reasonably Estimable
Probable	Accrue and Disclose	Disclose
Reasonably Probable	Disclose	Disclose
Remote	Disclose	Nothing

- The American Institute of Certified Public Accountants (AICPA) issued a statement (SOP 96-1) providing guidance on “probable” and “reasonably estimating” for *remediation liabilities*. This could become a precedent for dealing with other environmental liabilities, though no one appears to be pushing it at the moment.
- SEC Staff Accounting Bulletin No. 92 (SAB 92) states that known environmental liabilities must be estimated and accrued and provides guidance on how to use and report ranges of estimates.
- The effects of SOA on existing disclosure rules are being reinforced by increased pressure to disclose from a variety of quarters, such as:
 - The General Accounting Office (GAO), based on its analysis of environmental disclosures (July 2004), is pushing the SEC to improve its tracking of information and to cooperate with the EPA. SEC has signaled support for GAO’s recommendations.
 - Shareholder resolutions are pushing for more disclosure, especially on climate change.
 - The American Society for Testing and Materials (ASTM) has developed guidelines for estimating monetary costs of environmental liabilities and for disclosure. ASTM is pushing these standards on the SEC. The SEC is pushing back, but the EPA has signaled support and some companies have already adopted these standards.
 - The community of “socially responsible investors” as well as institutional investors are pushing for greater disclosure, especially on climate-related information, e.g., CalPERS, Carbon Disclosure Project.
- SOA Section 404 requires management to establish and maintain “internal controls and procedures,” and to assess their effectiveness annually. This includes internal controls for EHS operations. Management’s assessment of the internal controls is subject to review by the auditor.
- SOA pushes EHS staff to review their processes and to look for decision points involving the companies analysis of environmental liabilities, e.g., whether to establish a loss reserve for an environmental liability and where to set the reserve. Corporations should be able to point to an established protocol for identifying, tracking, quantifying, and assessing the materiality of environmental issues.
- SOA ties the EHS systems further into the core business. EHS staff need to build teams and relationships with accounting and finance staff to identify and evaluate

environmental liabilities. These teams and their ability to work together could be subject to an auditor's review of a company and the sufficiency of their "internal controls." The VP of EHS should probably sit on a "disclosure committee" with other corporate officers.

- Companies should be aware of what their peers are disclosing. This can greatly effect what auditors and regulators deem to be "material."

PART B: Balance Sheet Accounting for Emissions Allowances and Credits

- Emissions allowances (issued by government agencies) and credits (certified by government agencies) have economic value that needs to be accounted for in financial balance sheets.
- Accounting standards have not been established yet, but the Financial Accounting Standards Board (FASB) in the U.S. and the International Accounting Standards Board (IASB) based in London have begun studying the issue. IASB issued formal guidance through its International Financial Reporting Interpretations Committee (IFRIC) in December 2004. Also, U.S. power companies have been booking SO₂ and NO_x allowances and credits for years, and therefore have established industry practice.
- Accounting practices by power companies will vary according to (a) the manner in which the asset was acquired (direct allocation by a government agency versus market purchase), (b) the type of company (regulated utility versus merchant plant), and (c) the classification of the instrument (asset, inventory, or intangible asset).
 - Directly allocated allowances can be booked on a "zero cost" basis, whereas purchased allowances are booked at cost (the market price that was paid). For tax purposes, this creates an incentive to use up any purchased allowances before using the "free" allowances. If a mix of purchased and free allowances are used for compliance, the expense can be calculated as a weighted average.
 - If the company is a regulated utility, it is regulated on a state-by-state basis by the PUCs, which generally treat allowances as "ratepayer regulatory assets." As such, the utility is not allowed to book a gain on allowances prices (i.e., a profit) because the gain would have to be returned to the ratepayer (Missouri is an exception and allows some gains on the value of allowances). As a result, there is little incentive for regulated utilities to trade allowances for financial gain, which is a market impediment. If allowances are auctioned by a government agency as opposed to given away for free ("grandfathered"), then utilities would likely be able to book gains on value.
 - Merchant plants, however, can realize a profit and will generally treat allowances like regular assets. Some have argued that market-to-market accounting is necessary, which means the value of the assets would have to be recalculated periodically based on the prevailing market prices.
 - Depending on how the allowances are classified on the balance sheet (as an asset, inventory, or intangible asset), any increase in value could be booked to either equity (balance sheet) or income statement.
- It is not clear how and when FASB may act to establish guidelines. Mergers and acquisitions in the power sector in recent years have created some pressure to

standardize the accounting treatment. This is because allowances are allocated in perpetuity to power plants, not companies per se. As a result, the allowances generally stay with a plant when it is sold, unless the purchase contract stipulates some other arrangement, which in turn leads to questions about valuation.

- The IASB International Financial Reporting Interpretations Committee (IFRIC) released an interpretation in December 2004 on "Emission Rights," i.e. allowances. This Interpretation is not yet adopted for use in the European Union, nor has the European Financial Reporting Advisory Group (EFRAG) submitted an endorsement. The guidance is considered controversial and has been strongly criticized. The Interpretation specifies that:
 - Allowances are intangible assets that should be recognized in the financial statements in accordance with existing IAS guidance on Intangible Assets (IAS 38).
 - When allowances are issued to a participant by government for less than their fair value, the difference between the amount paid (if any) and their fair value is treated as a "government grant" that is accounted for in accordance IAS 20 Accounting for Government Grants and Disclosure of Government Assistance. The grant is initially recognized in the balance sheet as deferred income. It is recognized subsequently as income on a systematic basis over the period for which the allowances are allocated, regardless of whether the allowances are held or sold.
 - Allowances that are purchased are initially recorded at cost.
 - As a participant produces emissions, it recognizes a provision for its obligation to deliver allowances in accordance with IAS 37, Contingent Liabilities and Contingent Assets. There is no obligation to make a provision at the start of the compliance period or when allowances are received. The liability is measured at the best estimate of the expenditure required to settle the present obligation (based on past emissions) at the balance sheet date. This will usually be the present market price of the number of allowances required to cover emissions made up to the balance sheet date.
 - Because of the way IAS37 and IAS38 are currently written, there is a mismatch in how an increase in the value of allowances will impact financial statements. If the price of allowances rise, the incremental value of allowances is booked to equity, while the incremental increase in the contingent liability is booked to the income statement. This means that a company could have sufficient allowances to cover its liability yet see operating margins decrease artificially.
- Another issue is the classification of assets as either "current" or "non-current" assets on the balance sheet, which can be problematic in relation to banking of allowances over time.
- In the EU ETS, allowance transactions are subject to the "value added tax" (VAT). For purposes of the VAT, allowances are not considered to be "financial instruments." The international sale of emissions allowances will be taxable in the State where the buyer takes delivery.