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Creating institutional meaning: Accounting and taxation law perspectives of carbon permits

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ABSTRACT

Emissions trading schemes based on the idea that markets are an efficient means to allocate resources have created the need for a tradeable right, the carbon permit. The measurement and recognition of this right has the potential to significantly affect the financial reports and cash flows of entities and is therefore of interest to market participants. The purpose of this paper is to analyse the different meanings attached to the term, carbon permit, from two institutional frameworks, accounting and taxation, using discourse analysis of identified key documents available during the design and public discussion of the proposed Carbon Pollution Reduction Scheme in Australia.

1. Introduction

Emissions trading schemes (ETS) proposed to mitigate greenhouse gas (GHG) emissions have evolved from the neoclassical economic idea that markets are an efficient method to allocate resources. Inefficiencies or market failure can result where markets operate in imperfect conditions. Neoclassical economists would argue that in the relatively short time since industrialisation, the world has faced a situation of environmental crisis from a market externality, GHG pollution (Lohmann, 2009). This market failure is said to be correctable by market systems with greater information symmetry and more reliable price discovery through regulatory intervention. Neoclassical approaches are grounded in the argument of economic efficiency, often reduced to a cost–benefit analysis of alternatives. This creates a narrow framing of the issue of GHG pollution and moves it to a discussion of the optimal mix of markets and regulation (Milne, 1996).

Trading schemes designed to mitigate greenhouse gas emissions, such as cap-and-trade, have created the need for a tradeable right, the carbon permit, to facilitate market transactions. Therefore, a carbon permit must have the characteristics of exclusivity and transferability to discover a market price and assist cost–benefit decision-making for market participants, whether industry or speculative investors. The purpose of this paper is to analyse the different meanings attached to a carbon permit[2] from two institutional frameworks in Australia: accounting, which provides informational content and price; and income taxation, which provides regulation and compliance. The paper responds to the idea that carbon markets are "the existing and planned experiments in changing capitalism's bottom line" and are "widely diffused worldwide, and involve many aspects ... beyond economics as widely conceived" (MacKenzie, 2009, p. 453). These experiments, therefore, need

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[2] Australia has preferred to call the tradeable right a permit rather than an allowance.

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multiple witnesses, especially the crucial "nuts and bolts" of construction (MacKenzie, 2009, p. 454) of which accounting and taxation are examples.

The introduction of an ETS in Australia has raised significant accounting and taxation issues for entities, especially in the absence of authoritative guidance. The accounting and taxation treatment of a tradeable right will impact on cash flows, balance sheets and profit and loss calculations for companies both nationally and internationally (Casamento, 2005). Therefore, the accounting and taxation calculations are not inconsequential in terms of informational content and regulatory compliance. The response by national and international standard-setters to account for emissions[3] has been slow to develop. Two notable attempts to promulgate guidance has arisen from the Financial Accounting Standards Board (FASB) Issue 03-14 *Participants Accounting for Emissions Allowances under a "Cap and Trade" Program* and the International Financial Reporting Interpretations Committee (IFRIC) IFRIC 3 *Emission Rights*. The objective of both was to provide a "comprehensive accounting model for participants in a cap-and-trade emissions reduction program" (FASB, 2007, p. 1). However, FASB removed the issue from its agenda in 2003 citing implications for accounting for other forms or schemes as the primary reason (FASB, 2007). IFRIC 3 was withdrawn in 2005 following stakeholder concerns regarding the valuation mismatch between assets and liabilities arising from the European Union (EU) ETS. FASB and the International Accounting Standards Board (IASB) are currently conducting a joint project to "develop comprehensive guidance on the accounting for emissions trading schemes" (IASB, 2008, p. 1).

Taxation of carbon permit creates a plethora of issues for companies, especially considering the breadth of both direct and indirect taxation rules. The possible tax consequences influence cash flows and investment decisions of entities. In the U.S., guidance has been issued for the taxation requirements of acid rain allowances, although these may not be applicable to GHG emissions (Casamento, 2005). Unlike international accounting standards that have a similar effect across national boundaries, revenue tax regimes are generally national. In Australia, the taxation of permits are to be "neutral as to an entity's decision to purchase or sell permits, or to undertake abatement activities" with "a simple taxation treatment [that] will assist with the implementation of the scheme by 2010" (Australian Government, 2008, p. 1).

The creation of an economic phenomenon, a carbon permit, provides a unique opportunity to explore the construction of institutional meaning and the role of institutional members in creating meaning. The right and subsequent obligation to emit during a specified period are defined, measured and recognized differently by the regulatory institutional frameworks of accounting and taxation law. It has been argued that "the beliefs and meanings of a society create knowledge of the world" (Gaffikin, 2007, p. 251) and this paper explores how these institutions influence and create meaning. Accordingly, knowledge or concept of reality is relative to the social context in which it exists. Accounting and taxation law institutions are also social phenomena which are created, practiced and perpetuated by their members (Chua, 1986). At a micro-level, social interaction provides an example of conflicts in society. Taken-for-granted knowledge or what is acceptable are "ideological constructs" effected through the rules of ownership, social exchange and the distribution of wealth in society (Chua, 1986, p. 619).

This "finite thing", the carbon permit, needs to be understood within the context it is created (Chua, 1986, p. 619), especially since capital markets deal in intangibles where their intrinsic value is a set of expectations (Andrew, 2008, p. 394). The following section provides a background of ETS in general and the regulatory and accounting frameworks for an ETS in the Australian environment. Section 3 expands the concept of institutional meaning, followed by a discussion of the method of interpretating key documents in Section 4. Sections 5 and 6 provide an analysis of the two institutions of accounting and taxation law, respectively, followed by a discussion in Section 7. Section 8 provides concluding comments.

2. Background

In 2007 the Australian Government ratified the Kyoto Protocol[4] committing to reduce GHG emissions in Australia to 60% of 2000 levels by 2050 (Department of Climate Change, 2008). Despite several options available, including a carbon tax, the Australian government chose an ETS on the assumption that markets are the best way to allocate resources (Andrew, 2008). Market based solutions to mitigate GHG generally rely on the economic assumption that managing the price of a carbon permit, either through taxation or other financial strategies, will allow regulators to manage supply and demand (Andrew, 2008). A Green Paper for the proposed design of the Carbon Pollution Reduction Scheme (CPRS) was issued for public comment in July 2008. Following public consultation, the White Paper for a CPRS was released in December 2008. The CPRS is a cap-and-trade system set to commence for most industries in 2010. A government or regulatory agency allocates allowances to a predetermined level or cap of GHG emissions and entities can sell their excess allowances or purchase allowances to settle future obligations in a trading market. Australia relies heavily on a carbon intensive economy both for

[3] Accounting for allowances in an emissions trading scheme has already been implemented in the US with the acid-rain trading scheme. This scheme uses a cap-and-trade system whereby allowances for sulphur dioxide are recorded at historic cost at the time of purchase. Where a company emits more than its allowance it accrues the estimated cost of obtaining allowances. FASB assumes companies account for emission allowances in the manner required by the 1993 Federal Energy Regulation Commission (FERC) Uniform System of Accounts guidance (Casamento, 2005).

[4] Australia ratified the United Nations Framework Convention on Climate Change in 1992 but did not ratify the 1997 Kyoto Protocol. Although Australia had a non-ratification policy until 2007, both Federal and State governments had introduced a number of measures to GHG emissions and address climate change. For example, the Federal Government introduced the National Renewable Energy Trading Scheme requiring energy retailers to procure electricity from renewable sources by purchasing Renewable Energy Certificates from renewable energy generators. In 2003, a state-based trading scheme was introduced for the energy sector by creating tradeable abatement certificates corresponding to GHG benchmarks (Carmody and Willis, 2005).