

Accounting for the Safeguard Mechanism

Reporting update

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Highlights

- Summary
- Key elements of the legislation
- Accounting considerations
- Further support

Summary

The '**Safeguard Mechanism**' is a legislated framework in Australia for heavy emitting facilities (approximately 215 facilities producing more than 100,000 tonnes carbon dioxide equivalent (t CO₂-e) each year) to measure, report and manage their carbon emissions by setting baselines and requiring facilities to keep emissions at or below a respective baseline for this facility.

The Australian Government's *National Greenhouse and Energy Reporting (Safeguard Mechanism) Amendment (Reforms) Rules 2023* has been passed by Parliament, with the new arrangements **taking effect from 1 July 2023**.

On an annual basis, each covered facility is required to report its emissions to the Clean Energy Regulator. A facility with an above-baseline performance during a compliance year will have an obligation to settle their over-emission and will need to consider if a **provision** is required to be recognised at a reporting date.

Conversely, a facility with a below-baseline performance during a compliance year can apply to receive Safeguard Mechanism Credits (SMCs) and will need to consider government grant accounting for the **carbon credits**.

"The Safeguard Mechanism legislation is designed to encourage heavy emitting facilities to actively manage their emissions. For preparers of financial reports of impacted entities, this will likely increase the level of complexity in determining when to apply government grant accounting under AASB 120 or recognise provisions under AASB 137.

The significance of the legislation will also increase the level of scrutiny by stakeholders on financial report disclosures and other information presented by management."

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Accounting for the Safeguard Mechanism



June 2023

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Summary

The '**Safeguard Mechanism**' is a legislated framework in Australia for heavy emitting facilities (approximately 215 facilities producing more than 100,000 tonnes of carbon dioxide equivalent (t CO₂-e) each year) to measure, report and manage their carbon emissions by setting baselines and requiring facilities to keep emissions at or below a respective baseline for this facility.

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Key elements of the legislation

Key element description	Accounting considerations section
<p>The legislation applies on a facility-by-facility basis, meaning organisations with multiple in-scope facilities won't be able to combine/offset results of individual facilities to determine their compliance with Safeguard Mechanism reform. Instead, assessment should be performed for each in-scope facility.</p>	
<p>The compliance period is 1 July to 30 June each year, with reporting and settlement by March the following year.</p>	<p>1 Compliance period</p>
<p>A baseline is determined for each facility and is based on volume of emissions per unit of output. The legislation describes this as a production-adjusted (intensity) framework as opposed to having an absolute limit. The baseline is set each year to 2030 based on a defined weighting between site specific emissions intensity and industry average emissions intensity, and is reduced by 4.9% each year to 2030 (baseline decline rates from 2030 – 2035 to be set by 1 July 2027).</p>	
<p>Facilities who emit above the baseline at the end of a compliance period will have to settle their excess by surrendering Australian Carbon Credit Units (ACCUs)¹ or Safeguard Mechanism Credits (SMCs) purchased from facilities with below-baseline performance or banked from previous years.</p> <p>Facilities ceasing operations in a compliance period have a settlement obligation when year to date emissions is above the baseline and year to date emissions exceed 100,000 t CO₂-e.</p>	<p>2 Should provisions be recognised for over-emissions?</p>
<p>Facilities who emit below the baseline each year can apply to receive SMCs. Following this application, SMCs are issued by the Clean Energy Regulator (the Regulator) by January the following year. Those credits could be sold to facilities with above-baseline performance or banked (currently up to 2030, and to be reviewed in 2027) for future use or shared between facilities under the same operator.</p>	<p>3 Safeguard Mechanism Credits (SMCs)</p>

¹ Australian Carbon Credit Unit (ACCU) is an existing type of carbon credit units in Australia issued by the Clean Energy Regulator. Each ACCU issued represents 1 tonne of carbon dioxide equivalent (t CO₂-e). ACCUs are issued for a number of eligible activities outside of the Safeguard Mechanism framework.

Key elements of the legislation

Key element description	Accounting considerations section
Facilities are allowed to borrow up to 10% of the baseline each year.	<u>4 Borrowing application</u>
Multi-year monitoring period (MYMP) can smooth the compliance period up to 5 years.	<u>5 Multi-year monitoring period (MYMP)</u>
For many facilities the baseline emission intensity in the first year will not be determined until later in the year (application closes 30 April 2024), with formal confirmation from the Regulator to follow after the compliance period end.	<u>6 Additional complexity in the first year</u>

Accounting considerations

1 Compliance period

The Safeguard Mechanism reform will commence on 1 July 2023.

The following timeline summarises key dates within the compliance period of the scheme:

1 July 2023 Safeguard Rule Reform is effective	FY23 Compliance year timeline	30 Jun 2023 End of FY23 compliance period	31 Oct 2023 NGER Reporting deadline for FY23	28 Feb 2024 ACCU Surrender date for FY23. Borrowing application date for FY24		
	FY24 Compliance year timeline *	1 July 2023 New Safeguard Mechanism commences	30 Apr 2024 Application for Site Specific Emissions Intensity value	31 Oct 2024 NGER Reporting deadline for FY24.	15 Nov 2024 MYMP application	~ 31 Jan 2025 SMCs issued – note this now requires an application by 31 January each year

* FY24 Compliance year timeline applicable to FY25 and beyond

When a **reporting period** of a facility is **in line with the end of a compliance period** (i.e. 30 June), facilities will need to estimate their level of emissions at the compliance date, as their actual emissions reporting may be not audited/finalised until 31 October.

Additional complexities may arise for situations **when a reporting date is different to a compliance date**, for example the entity has an interim reporting period at 31 December. In this case, to determine if a provision should be recognised at the interim date, the facility will have to estimate emissions at reporting date and apply judgement to determine if it expects to exceed its baseline by the end of the compliance period. Refer to section 2 **Should provisions be recognised for over-emissions?** below for more detail of the provision accounting.

In the first compliance year (i.e. year ended 30 June 2024), it is likely the baseline emission intensity for many facilities will not be finalised until later in the year (i.e. facilities will be required to submit their applications by 30 April 2024). For this first year, entities with an interim reporting period before 30 April 2024 will also have to estimate their baseline at the reporting date. Refer to section 6 **Additional complexity in the first year** below for more detail.

Accounting considerations (cont.)

2 Should provisions be recognised for over-emissions?

Recognition

At each reporting date, in-scope facilities need to consider if a provision to settle an obligation for emitting above the baseline is required to be recognised under AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*.

In our view, the obligating event under the Safeguard Mechanism framework arises when:

- the facility has emitted more than 100,000 t CO₂-e,
- the emissions on production to date exceeds the baseline, and
- the facility has no realistic alternative for the remainder of the year to reduce emissions below the baseline.

Example 1A:

A facility has an interim reporting date of 31 December 2025 and has emitted more than 100,000 t CO₂-e as at this date. As at 31 December 2025, emissions exceeds the baseline based on production to date.

Management determines the facility has realistic plans to produce more efficiently using lower carbon fuels in the second half of the year, to bring estimated emissions below the baseline at the end of the compliance period (i.e. 30 June 2026).

Therefore, an obligating event does not exist at 31 December 2025 and no provision is recognised.

Example 1B:

Conversely, management determines the facility does not have realistic plans to reduce emissions below the baseline at the end of the compliance period. In this situation, an obligating event does exist at 31 December 2025 and a provision is recognised.

An alternative view an entity may apply is that the obligating event arises when the facility has emitted more than 100,000 t CO₂-e and the emissions based on production to date exceeds the baseline. Management's plans for the remaining compliance period is irrelevant to the analysis.

Example 2:

Under the alternative view, in the above Example 1A, an obligating event exists and a provision is recognised at 31 December 2025. If the facility achieves emissions at 30 June 2026 below the baseline, the provision recognised at 31 December 2025 is reversed in the second six months P&L.

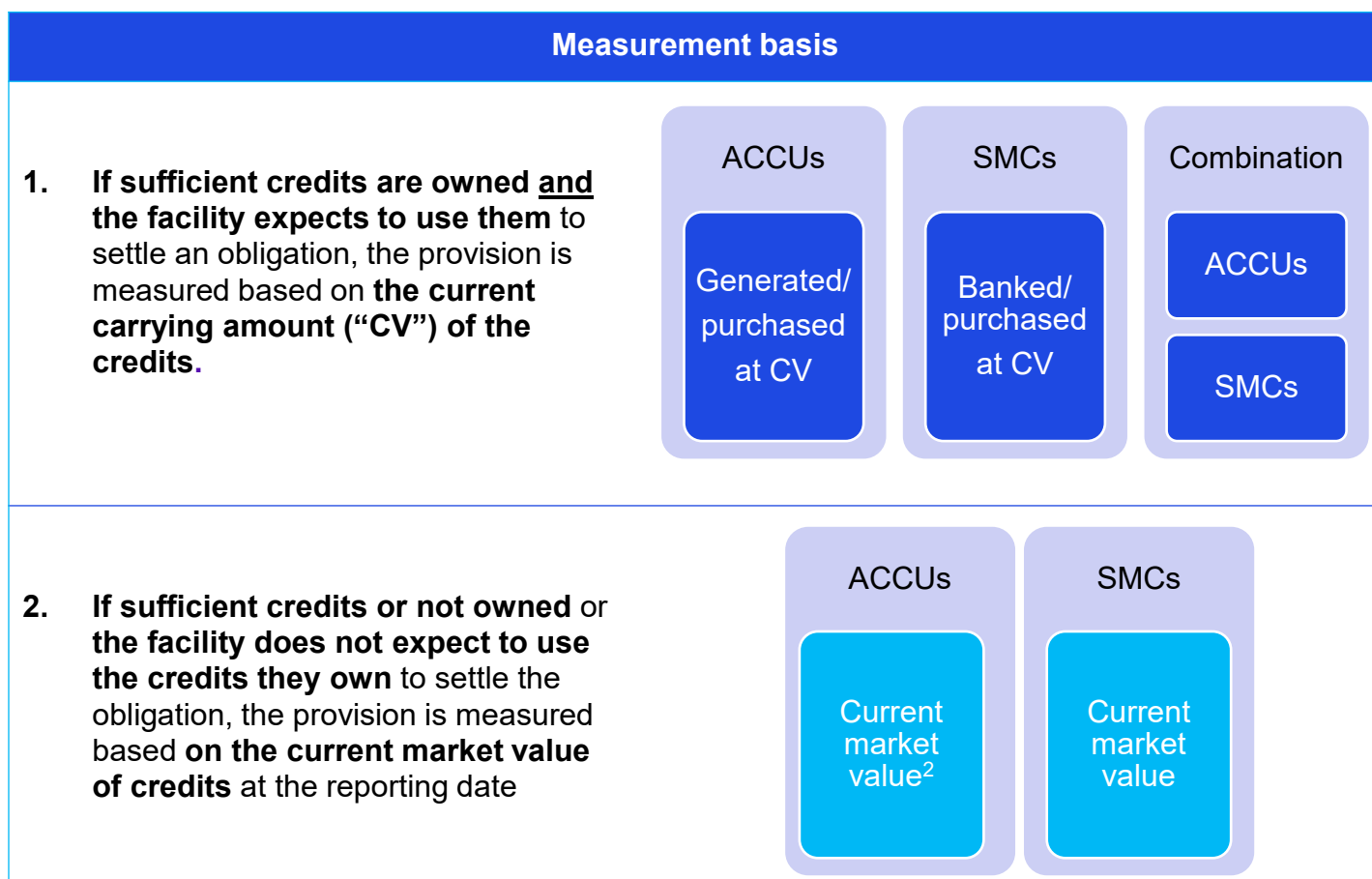
Accounting considerations (cont.)

2 Should provisions be recognised for over-emissions? (cont.)

Measurement of provision

Provisions are measured at the best estimate of the expenditure required to settle the present obligation at the reporting date.

Facilities with above-baseline performance will be able to settle their excess by surrendering Australian Carbon Credit Units (ACCUs) or SMCs purchased from facilities with below-baseline performance or banked from previous years to the Regulator.



2 To manage concerns about price volatility and availability of credits, the government has proposed a cost containment measure which will provide for ACCUs to be sold to facilities at a fixed price. This is planned to be set at price of \$75 per tonne of CO₂-e in 2023–24, increasing with the CPI plus 2% each year with a review in 2026-27. This measure is only to be used as a last resort and as such, ACCUs can only be bought by facilities under this measure if they are in an over-emitter situation.

>> Refer to Example 3 on page 11 for more detail.

Accounting considerations (cont.)

3 Safeguard Mechanism Credits

Recognition

Australian accounting standards do not have specific guidance on accounting for carbon credits. In our view, receipt of SMCs will meet the definition of a government grant of a non-monetary asset and be accounted for under AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance*.

In recognising the government grant, the facility chooses an accounting policy to be applied consistently, and can recognise the SMCs at **either fair value or at a nominal amount**. AASB 120 notes that fair value is the usual approach for non-monetary grants.

>> Refer to Example 3 on page 11 for more detail.

AASB 120 requires “government grants, including non-monetary grants at fair value, to be recognised only when there is **reasonable assurance** that:

- a) the entity will comply with the conditions attaching to them; and
- b) the grants will be received”

SMCs can only be issued where the facility has below-baseline performance at the end of a compliance period. The receipt of SMCs as a government grant is only recognised where there is reasonable assurance that the facility will be below its baseline at the end of a compliance period and the SMC application successful.

We believe the effectiveness of decarbonisation programs, and evolving processes for capturing and measuring emissions intensity on a regular basis would likely mean it will be **difficult to achieve reasonable assurance before the end of a compliance period**. Further assessment will be required to determine whether the reasonable assurance threshold is delayed beyond the end of a compliance period until closer to 31 October when reporting to the Regulator on actual emissions occurs, or 31 January, the SMC application deadline.

If recognised at fair value, the grant is recognised as deferred income initially and in profit or loss **on a systematic basis** over the compliance period, regardless of whether the allowance received continues to be held by the entity.

Given that facilities will most likely incur all (or materially all) relevant costs in advance of receiving the associated SMCs, it is generally expected that **income will be recognised immediately once the reasonable assurance threshold is achieved**, if SMCs are recognised at fair value.

Accounting considerations (cont.)

3 Safeguard Mechanism Credits (cont.)

Classification of credits and subsequent accounting

The Standards do not have any specific guidance on accounting for carbon certificates. In our view, a facility should choose an accounting policy, to be applied consistently, to account for SMCs based on the following approaches:

Classification	Subsequent accounting
<p>As intangible asset: under this approach, it is argued that SMCs are identifiable non-monetary assets that do not have physical substance and therefore meet the definition of an intangible asset.</p>	<p>Intangible assets carried at cost less any accumulated amortisation and any accumulated impairment losses (AASB 138 <i>Intangible Assets</i>).</p> <p>The revaluation model under AASB 138 cannot be applied as there is no active market for SMCs at present.</p>
<p>As inventories: under this approach, it is argued that SMCs are effectively an input to be consumed in the production process, similar to inventories.</p>	<p>Lower of cost and net realisable value (AASB 102 <i>Inventories</i>).</p>

We believe that the above accounting policy choice should be applied regardless of whether SMCs are received from government or bought and also applies to ACCUs bought to meet obligations under the legislation.

In our view, SMCs are not financial assets in the scope of AASB 9 *Financial Instruments*.

Accounting considerations (cont.)

3 Safeguard Mechanism Credits (cont.)

Example 3:

On 30 June 2025, management estimated a facility has emitted 290,000 t CO₂-e, which is **below the baseline** of 300,000 t CO₂-e for this compliance year. Therefore, no provision is recognised and instead the facility is entitled to SMCs. Management determine the reasonable assurance threshold for government grant recognition is met at 30 June 2025, and the facility recognises expected receipt of **10 thousand SMCs as a government grant**. It is the organisation's accounting policy to classify SMCs as intangible assets. The facility decides to bank these SMCs for future use.

On 30 June 2026, management estimates the facility has emitted 305,300 t CO₂-e, which is **above the baseline** of 285,300 t CO₂-e for this compliance year. Therefore, an obligating events exists and **a provision is recognised** in relation to facility's obligation to settle their over-emissions by 20 thousand tonnes for the compliance year ended 30 June 2026. The facility is planning to use the SMCs they banked from the prior year to settle the obligation.

a. At nominal amount, \$'000

b. At fair value, \$'000

30 June 2025 Market value of SMCs at 30 June 2025 is \$35.

DR Intangibles	-
CR Deferred government grant income	-

10 thousand SMC's recognized at nominal amount

DR Intangibles	350
CR Deferred government grant income	350

10 thousand SMC's recognised at fair value.

DR Deferred government grant income	350
CR Government grant income (P&L)	350

Government grant income recognised in P&L assuming costs to which grant relates have been incurred.

30 June 2026 Market value of SMCs at 30 June 2026 is \$50.

DR Expense	500
CR Provision	500

Provision recognised for 20 thousand tonnes, 10 thousand measured at nil carrying value of SMCs banked from prior year and 10 thousand tonnes at market value of SMCs

DR Expense	850
CR Provision	850

Provision recognised for 20 thousand tonnes, 10 thousand measured at 350 carrying value of SMCs banked from prior year and 10 thousand tonnes at market value of SMCs

Accounting considerations (cont.)

4 Borrowing application

Facilities are able to borrow up to 10% of the baseline each year until 2030, with a 10% interest rate (2% for the first two years of the reforms) applied in the year after borrowing occurs. Any borrowing must be trued up in the following year. A facility cannot generate SMCs in a year they applied for borrowing. The borrowing application is approved after the compliance period in February of the following year.

A detailed Illustrative example has been included as part of the [Safeguard Mechanism Reforms Position Paper](#) issued by the Department of Climate Change, Energy, the Environment and Water (refer to Illustrative Example 4.2 for further details).

Borrowing arrangements are intended to help facilities manage their compliance obligations when doing so might otherwise be costly or difficult. A facility will need to make an assessment as to whether the borrowing application process represents a substantive process or not. In the table below we summarise the accounting implications for each assessment:

	Not a substantive process	Substantive process
Impact on obligating event and when a provision is recognised	The baseline used to determine an obligating event should be determined as “the baseline+10%” in each particular year.	The baseline used to determine an obligating event excludes the 10% borrowing. Accounting for additional 10% is only possible when a facility applies and is approved for a borrowing.

Accounting considerations (cont.)

5 Multi-year monitoring period (MYMP)

Facilities will be able to apply for “smoothing” of the baselines over five years if they can demonstrate that abatement technology is not currently available but will be accessible in future years. Smoothing allows facilities to average out exceedance in an initial year(s) with below-baseline emissions in later years. Facilities are not eligible for SMCs whilst on a MYMP.

Facilities will only be able to account for MYMP once their application is approved.

The principles established above for provision accounting apply equally to facilities approved for MYMP. The difference would be that a compliance period will be a five-year period, and not a one-year period.

Facilities are allowed to apply for MYMP after the first year of baseline exceedance. It is expected that by the time a facility applies for smoothing, they have recognised a provision for the first year of exceedance. Once the application for smoothing is approved, the facility re-assesses the provision previously recognised under their annual baseline with reference to their new 5-year smoothed baseline applicable.

Example 4:

At the end of the 30 June 2024 compliance period, facility has emitted more than 100,000 t CO₂-e with emissions exceeding the baseline for this compliance year. Therefore, a provision was recorded at 30 June 2024 for the facility’s obligation to settle their above-baseline performance for the compliance year ended 30 June 2024.

To curb future emissions, the facility has approved a plan to invest in new technology which is expected to become available in FY2025 and expected to significantly reduce emissions once fully implemented in FY2026. On 15 November 2024 the facility applies for an MYMP.

Once the application is approved, the facility re-assesses the provision previously recognised at 30 June 2024 with reference to their new 5-year smoothed baseline and considers whether any reversal of the previously recognised provision is required.

Discussion of how the MYMP accommodates emerging technologies is included as part of the [Safeguard Mechanism Reforms Position Paper](#) issued by the Department of Climate Change, Energy, the Environment and Water (refer to Section 4.6 for further details).

Accounting considerations (cont.)

6 Additional complexity in the first year

Additional accounting complexities may arise in the first compliance year (i.e. year ended 30 June 2024), as for many facilities the baseline emission intensity will not be determined until later in the year (i.e. 30 April 2024), with formal confirmation to follow post the end of the compliance period.

Existing facilities in-scope will have their baseline emission intensity set using a hybrid model initially weighted towards the use of site-specific emissions-intensity values, transitioning to industry average emissions-intensity values by 2030. These existing facilities will need to apply for site-specific emissions-intensity values (and be accompanied by an audit) by 30 April 2024. The formal confirmation of the baseline for the first compliance year will be provided by the Regulator after the receipt and acceptance of the audited applications.

New facilities in-scope will have their baseline emissions-intensity values established based on international best practice emissions-intensity benchmarks, adopted for Australian circumstances. The Regulator is yet to determine the details, so it is likely that a baseline emissions-intensity value for new in-scope facilities will not be confirmed until after the end of the compliance period.

Depending on a reporting period date, **during the first year of the legislation, in-scope facilities will be at different stages of estimating their baseline emissions intensity** applicable for the first compliance year. This will require management to apply additional judgement in determining the provision accounting as they will need to also develop their best estimate of the level of baseline emission intensity applicable for the first compliance year.

Accounting considerations (cont.)

7 Other matters

Impairment testing considerations

Facilities in-scope should incorporate the impact of the legislation into their recoverable amount calculations for both fair value less costs of disposal (FVLCD) and value in use (VIU) models, including for 30 June 2023 reporting periods.

Compliance with the legislation may result in additional forecast cash outflows either in relation to purchasing of the SMCs/ACCUs to settle the over-emission obligation or in relation to additional capital expenditure to reduce the facility's emissions.

When incorporating additional capital expenditure into a VIU model, management may need to apply judgement whether forecast cash outflows maintain or enhance the facility's performance. In accordance with the requirements of AASB 136 *Impairment of Assets*, the benefits from capital expenditure to improve or enhance the facility's performance are not taken into account in a VIU model unless the capital expenditure is incurred, which in our view is the point of time when the capital project has substantively commenced. This represents a difference to a FVLCD model whereby capital expenditure is included in the cash flow forecasts consistently with market participant assumptions in accordance with AASB 13 *Fair Value Measurement*.

For facilities that are expected to emit below their baseline, the legislation may result in additional forecast cash inflows in relation to the expected receipt and subsequent sale of SMCs.

Management will ultimately need to ensure the assumptions used in the recoverable amount calculation are reasonable and supportable, and are appropriately disclosed in the financial report when considered to be material to the users.

Emissions intensive, trade exposed facilities

The treatment of **emissions intensive, trade exposed (EITE) facilities** will be a significant aspect of the new Safeguard Mechanism. These include trade exposed facilities undertaking a trade exposed activity or facilities facing an elevated risk of carbon leakage. Trade Exposed Baseline Adjusted (TEBA) facilities within the EITE category would be eligible for discounted decline rates (baseline on the level of compliance cost), to as low as 2% and 1% for non-manufacturing and manufacturing activities respectively.

Trade exposed facilities will be supported through the formation of a dedicated \$600 million Safeguard Transformation Stream within the **Powering the Regions Fund (PRF)**, as well as a targeted \$400 million for industries providing critical inputs to clean energy industries (including steel, cement/lime, aluminium/alumina).

Details of these grants have not yet been finalised. Facilities that are potentially eligible for the funding need to stay up to date with these developments and consider if government grant accounting under AASB 120 is applicable.

Accounting considerations (cont.)

7 Other matters (cont.)

Standard developments

The International Accounting Standards Board has proposed to undertake a project to make improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Possible amendments to the requirements of the standard could impact provision recognition accounting, so facilities in-scope should follow updates on this topic.



Further support

KPMG's [Australian resource centre](#) on the financial reporting impacts of climate change and developments in sustainability reporting.

Our resource centre provides an overview of the Australian regulatory landscape highlighting the increasing focus of climate change and sustainability within financial reporting and helps you consider the reporting impacts. Discover the latest developments in sustainability reporting both globally and locally.

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