

CFO insights: Do you have a carbon management strategy?



Regulatory changes related to greenhouse gas emissions in the United States are going to have a major impact on North American CFOs across a wide variety of industries. From the costs of compliance and reporting systems to accounting for the economic impacts of carbon in the income statement and balance sheet, CFOs will have to lead and execute the alignment of a carbon management strategy with the company's financial strategy. Despite the current recession, changes in the regulatory environment make the development of a carbon management strategy a likely and emerging imperative. In many industries, new reporting requirements beginning in 2011 are best met by having a strategy in place now.

Consider the following regulatory developments:

- The American Clean Energy and Security Act (also referred to as Waxman-Markey) was passed by the United States House of Representatives on June 26, 2009 but has not yet been passed by the Senate. This bill calls for nearly 20 percent carbon emission reductions through cuts of methane and carbon dioxide by 2020. The bill also calls for a cap and trade system for carbon emissions.
- In many energy and resource industries, the Environment Protection Agency (EPA) requires new carbon emissions disclosures for 2010 to be reported in 2011. Furthermore, in *Massachusetts et al. versus the EPA (Case No. 05-1120)*, the Supreme Court found that the gases that cause global warming are pollutants under the Clean Air Act. Thus the EPA can enact new rules to manage carbon emissions under existing law.
- The COP15 United Nations Conference on Climate Change in December 2009 seeks to frame a successor to the Kyoto Protocols before they expire in 2012. Given the Obama administration's strong commitment to a global protocol and the reduction of carbon emissions, there is a strong incentive to complete a Federal legislative package on greenhouse gas reductions in advance of the conference. If this is not

accomplished this year, there are strong incentives for the current administration to see new legislation in place before the next Congressional election cycle.

- New rules for disclosure across Europe and the Pacific, as well as demands by large buyers will require more investments in accounting for carbon emissions in the entire supply chain,

All these developments suggest that the United States and some other parts of North America are likely to adopt cap and trade and other emission control regulations in the near future. If legislation is not enacted through the Congress, the Supreme Court decision paves the way for the EPA to create new regulations based on the existing Clean Air Act. Thus it is imperative to build and execute a carbon strategy to respond to plausible changes.

What Should CFOs Do?

With new regulations, carbon is likely to become a source of liability. Carbon allowances can become assets that could potentially impact the financial accounts and performance of the company. As what was once an economic externality is increasingly internalized, CFOs need to prepare to incorporate the assets, liabilities and risks associated with managing carbon emissions into their financial and risk management processes. Internalizing this externality will require a number of steps. Specifically CFOs will need to take leadership with others in the company to develop and execute:

1. An overall strategy to manage carbon as a critical business variable
2. A governance model that allocates roles and responsibilities for managing carbon
3. Systems and processes for disclosure and reporting
4. Guidelines to account for carbon
5. Processes for compliance and risk management

In the next section, we discuss issues to address in each of the above areas.

Framing Overall Carbon Management Strategies

The CFO and the finance organization have to be a critical part of a company's formulation of its carbon management strategies. Why? Because carbon management strategies can have a major impact on future income statements and balance sheets, especially in industries like energy and resources, chemicals, manufacturing, and high technology. Some scientists and the U.S. government believe that carbon emissions will need to be reduced by 80 percent. This will require significant changes in many industries and, in the context of a growing population, require substantial and rapid drops in per capita emissions. These reductions will also require long range investments in carbon emission reductions and compliance with new regulations. Thus, CFOs need to prepare for the financial impacts of carbon, and should consider catalyzing an overall carbon strategy to formulate responses to:

- **The Impact of Carbon Regulation and Climate Change on Company Strategy.** Specifically, companies will have to assess how changes in climate and regulations are likely to impact the demand for products and services; the cost of delivering products and services; the locus of operations; and value and supply chain relationships. In addition, companies will have to understand the carbon implications of existing and planned investments, and account for carbon costs in all future investments.
- **Uncertainty in the Regulatory and Technology Environments.** Regulations and technologies for managing carbon are still a moving target. We know that it is almost inevitable that there will be more comprehensive requirements to manage and reduce carbon emissions. But there are considerable uncertainties to the final regulations, the extent or regional differences (i.e. state versus national regulations) and effective technologies and approaches to address these emerging requirements. We recommend managers adopt scenario planning for their companies to envision, assess and plan for alternative contingencies.

- **Reducing and Managing Greenhouse Gas Emissions.** Company managers will have to decide where and how they will reduce carbon emissions. This may require investment in strategies and technologies for carbon sequestration, and reducing the carbon footprint of the company through initiatives such as energy and travel reduction and using substitutes in the manufacture or delivery of services. Alternate ways for complying with emissions targets may include the purchase of carbon offset credits and applying for getting all available carbon allowances permitted by the government and regulatory bodies.

We find many companies have simply not begun to align financial and carbon management strategies, or prepare adequately for the impending changes. Many of these organizations may find themselves scrambling to adjust to new regulatory demands in the next two years.

Creating a Governance Framework

Managing carbon will require participation from multiple groups in a company — from the production and operational groups to the financial and risk management groups. But how should companies organize their planning and carbon management capability? This varies considerably across companies. Often a group-focused environment, health and safety may deal with carbon. But in some companies the corporate development capability is responsible for creating and executing carbon management plans and can report into the CFO organization.

What is important is a governance framework that clearly clarifies the roles, responsibilities, requirements and decision rights across different stakeholders in carbon management planning, execution and risk management. The governance model for carbon can extend from the board level to functional and department levels. For example, at the board level, the board has to consider if major capital projects require a section on the cost of carbon under different regulatory scenarios. Should this information be required or voluntarily disclosed by project proposers? The board also has to consider the risks

associated with carbon trading and regulatory risks. At other levels of the organization, clarity is required as to where planning and accounting for carbon resides and who has the rights and responsibilities to purchase carbon offsets and trade in carbon.

Today, in many companies, we find a multiplicity of decentralized efforts around managing carbon. Moving expeditiously to establish a clear governance framework that articulates roles, responsibilities and decision rights across different stakeholders is vital to managing compliance risk while efficiently accounting for carbon. CFOs can play a key role in creating the governance models for these initiatives.

Systems and processes for information gathering, disclosure and reporting

Current regulatory strategies for cap and trade are distinct from a carbon tax because the regulation puts a price on carbon; making it a financial liability on income statements and balance sheets. This means that CFOs need to be comfortable with the processes around generating the reports and collecting data about carbon and greenhouse gas emissions. To start, companies will need to measure and establish their carbon footprints both within their organization and within their supply and delivery chains. This will require new documented policies, processes, controls and systems to track carbon emissions. Beginning in January 2010, we expect that a set of companies above a certain threshold for size and emissions will have mandatory reporting requirements in the United States. This will require investment in software and services to track the carbon emissions and associated assets, to develop reports on compliance — and beyond, to carbon trading positions and associated risks — and the financial impacts. Today we find leading companies are investing in the requisite tracking and reporting systems to establish one system of record as it relates to anything carbon, and reconcile and resolve inconsistencies in the data. Fortunately a number of software and systems vendors are beginning to deliver systems to support reporting.

Accounting for Carbon

Carbon management raises a variety of accounting issues. How should carbon offset credits be accounted for? How should allowances be treated from an accounting perspective? How should they be valued? How will existing assets and products be impaired by the costs of addressing new regulatory requirements? If carbon allowances are traded with third parties or amongst subsidiaries within a company, what are the tax implications? Will the latter issues be considered material in an audit?

Bringing carbon into the company's accounting framework will require consideration across various parts of the finance organization. From the treasury department, to trade carbon allowances or hedge against future costs; to tax, to consider the tax implications and credits associated with carbon emissions; to the controller's office, to oversee the tracking and reporting. Despite the current crisis of a recession, it will be prudent to assemble a multi-functional team within finance, drawing on multiple competencies, to begin planning for the best ways to integrate the management of carbon with the finance organization. We find companies in the power and utilities sector most prepared to report their emissions and account for it. However, few companies across industries have considered the full financial and accounting impacts of a cap and trade regulatory regime.

From Carbon Accounting to Compliance and Risk Management

Beyond accounting for carbon, companies will have to comply with new regulations for carbon reduction. This may be done by reducing carbon through the adoption of new technologies or by using carbon offsets or allowances and credits. Regardless of the strategy, companies will require sufficient controls to verify carbon reductions and compliance with regulations. The risks of non-compliance should also be identified, since companies will have to guard against non-compliance. This in turn will require an audit of carbon programs and compliance, as well as the capacity for corrective action in the event of problems. The finance or the risk management organization will have to frame the core risk control and compliance processes around carbon.

Summary

It is almost inevitable that United States federal, regional or state initiatives will increasingly require the management of carbon emissions in the near future. Cap and trade and other regulations for carbon emissions are likely to directly impact income and balance sheet statements in many industries. CFOs will have to take the lead in catalyzing the various changes outlined above to effectively align carbon management and the financial strategies.

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