Australian Government
Department of Climate Change, Energy, the Environment and Water

Safeguard Mechanism

Draft Earnings Before Interest and Tax (EBIT) Guidelines

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Contents

1. Defining and calculating EBIT

These guidelines are to be used by Safeguard facilities to calculate a facility level EBIT for the purpose of applying for a trade-exposed baseline-adjusted determination in accordance with the *National Greenhouse and Energy Reporting (Safeguard Mechanism) Rule 2015* (Safeguard Rule). These administrative guidelines should be read in conjunction with the EBIT Guidelines Explanatory Document and consistently with the Safeguard Rule.

1.1 A facility is defined under Section 9 of the *National Greenhouse and Energy Reporting Act 2007* (NGER Act) and the regulations made under that section. In these guidelines "Facility" refers to the facility to which the trade-exposed baseline-adjusted (TEBA) determination relates to. The Facility boundary used to determine the EBIT must be the same as the facility boundary used for reporting under the NGER Act.

1.2 The guidance provided in this document should only be applied to calculate a facility level EBIT for the purpose of applying for a determination that the Facility is a TEBA facility. It must not be used for any other financial reporting obligations.

1.3 When applying to the Regulator for a determination that the facility is a TEBA facility in a particular financial year (the first financial year) and the next 2 financial years, the responsible emitter must calculate their facility's EBIT for the first financial year.

1.4 As per Subsection 37(2) of the Safeguard Rule, EBIT of a facility for a financial year is to be calculated in accordance with Australian Accounting Standards (to the extent applicable) as in force for the relevant financial year and any EBIT Guidelines that are in force at that time. For this purpose, the EBIT guidelines prevail over the Australian Accounting Standards to the extent of any inconsistency.

1.5 For the purpose of applying for a TEBA determination, a facility's EBIT is defined as its revenue minus expenses with interest expense and income tax expense or benefit added back, for all revenue and expenses incurred through activities and ancillary activities undertaken by the Facility within its defined NGER boundary.

$$\begin{aligned}\boldsymbol{EBIT} \;=\; & \boldsymbol{revenue - expenses}^{1} + \boldsymbol{interest\ expense} \\ & + \boldsymbol{income\ tax\ expense\ or\ benefit}\end{aligned}$$

1.6 Components of EBIT and required calculation steps are outlined in Appendix A to provide guidance on how each component is calculated in accordance with these guidelines and the application of Australian Accounting Standard requirements. The different components of the EBIT proforma calculation are explained in Section 2.

[1] Expenses includes all expenses in the determination of earnings. This includes, but is not limited to operating costs, supplier costs, salaries and wages, interest expense, tax expense or benefit and depreciation and amortisation.

2. Components of EBIT calculations proforma

This section outlines what can and cannot be recognised under each EBIT component consistent with Appendix A.

2.1 Revenue from external customers

2.1.1 Revenue of the Facility from external customers (third parties) should be calculated and recognised under *AASB 15 Revenue from Contracts with Customers (AASB 15).*

2.2 Revenue from other sources other than that recognised under 2.1.1

2.2.1 Transactions resulting in the transfer of goods and services to related parties (defined in *AASB 124 Related Party Disclosures*) may not be typically recognised as revenue under *AASB 15* due to their nature. However, they represent activities performed by the Facility that generate revenue in the final products and must be accounted for to enable the calculation of an EBIT at the facility level, especially where revenue is not normally recorded.

2.2.2 Revenue from the undertaking of activities by the Facility not recognised under section 2.1.1 need to be determined and recorded as part of the calculation of EBIT. Such transactions should be accounted for at arm's length as if they are transacted with an independent third party under normal business commercial terms, unless otherwise allowed by the guidelines. For example, the transfer of alumina from an alumina refinery to an aluminium smelter where the parties are related and the exchange would normally be non-monetary.

2.2.3 Where a Facility does not normally recognise revenue from external customers (for instance a Joint Venture where the output is provided to the Joint Venture participants or their related sales agent), the revenue for the Facility is the revenue generated by the sale of the output provided to the related party for sale to their respective customers.

2.2.4 Where the Facility does not generate external revenue and does not provide its product to a sales agent or joint venture participant as envisaged under 2.2.3 but provides the product to a related party for either direct sale or further processing and subsequent sale to a third party, the revenue to be recognised is equal to the market value for the goods or services produced. The market value should be referenced to an active market for the sale of the relevant output.

2.2.5 Market value of the transferred goods must be derived from the average daily market price for the first financial year from the most appropriate commodity exchange.

2.2.6 Where market value cannot be calculated, the revenue for the transaction is equivalent to the aggregate revenue generated by the sale of the final product to third parties, proportionally allocated to the Facility based on the expense incurred in producing the quantity of the intermediary good required in the production of that product compared to the total costs of producing the product in its saleable form.

2.2.7 The methodology used in the application of paragraphs 2.2.2 to 2.2.6, including appropriate supporting calculations, must be provided to the auditor of the TEBA application.

2.2.8 Where activities are undertaken at the facility that are not part of the activity or series of activities that constitute the facility (including ancillary activities), any revenue and the associated costs must be excluded from the calculation of EBIT. For instance, if a facility provides payroll services for other entities or components of the broader group, the associated revenue and costs would not form part of the EBIT determination.

2.3 Grant income

2.3.1 Grant income received that is directly attributable to the activities of the Facility including assistance for operating the assets of the Facility must be recognised as Other Revenue. As per

Subsection 37(4) of the Safeguard Rule, any funding provided for the financial year under the Powering the Regions Fund must be excluded from the Facility's revenue for the financial year.

2.4 Direct costs

2.4.1 Direct costs include all costs that are directly attributable to the operating activities of the Facility and must be included in Total Expense. These include direct material inputs, work in progress, direct labour, depreciation of assets used for the production process, amortisation, interest expense or finance costs and any other expenses such as consumables, for example, electricity and water, which are directly related to the production activities performed by the Facility.

2.4.2 For all direct costs incurred by the Facility for the purchase of goods and services provided by related parties, where transfer pricing rules apply to those costs, the transfer pricing determined price is to be used for the expense recognition. Where such related party purchases are not directly covered by transfer pricing rules, the cost to be used in the determination of the EBIT is to be calculated using the same methodology as if transfer pricing rules applied.

2.4.3 Australia's transfer pricing rules do not prescribe any particular methodology or preference to arrive at an arm's length outcome for cross border transactions. The responsible emitter should seek to adopt the method that is best suited to the circumstances of each case and consistently apply to all such interactions.

2.4.4 Documentation must be kept to substantiate compliance in line with Taxation Ruling TR97/20. The methodology or methodologies used should be disclosed to the auditor for each TEBA application, with any changes in methodology applied in subsequent applications being explained.

2.5 Indirect costs

2.5.1 Indirect costs relate to all indirect costs or overheads that relate to the management and administration costs relating to the production process occurring at the Facility and can be included in Total Expense. Management and administration costs not related to the Facility cannot be included e.g. head office management costs. The methodology of allocation of these indirect costs to the activities of the Facility should be considered with reference to *AASB102 Inventories* (paragraph 12 – 14) as a guiding principle and must be provided as supporting information to the auditor that is providing assurance of the TEBA application.

2.5.2 Where Facility management and administration costs are incurred by the head office at an aggregate level (such as payroll services) they must reflect exactly the proportion of costs incurred by the Facility compared to the total service provided for all components served by the service. Any such costs must be recorded at their incurred cost with no margin or markup and interest expense must be excluded from any allocation.

2.5.3 All head office allocated costs, whether directly charged or through a management fee or overhead allocation, such as Management Board costs should not be included as they are mostly administrative in nature.

2.6 Interest expense and tax expense/benefit

2.6.1 Interest expense and tax expense or benefit must be consistent with the boundary of the Facility. Where incurred at an aggregate level, these figures must be disaggregated and attributed in direct proportion to what is incurred by the Facility. These figures included in Total Expense will need to be adjusted and removed in the later section of the calculation as outlined in Appendix A.

2.7 Prior period adjustments

2.7.1 Prior period adjustments should be accounted for under *AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors.* This represents adjustments from prior period due to errors or change of accounting policy due to a new accounting standard becoming effective and with retrospective impact. Any adjustment recorded in the determination of EBIT under these guidelines must be consistent with that applied in the audited financial statements of the relevant entity for the financial period being evaluated.

2.8 Impairment of assets

2.8.1 Impairment of assets should be accounted under AASB 138 *Impairment of Assets* and must be included under Total Expense. Any adjustment recorded in the determination of EBIT under these guidelines must be consistent with that applied in the audited financial statements of the relevant entity for the financial period being evaluated.

2.9 Depreciation and amortisation of assets

2.9.1 Depreciation and amortisation of assets of the Facility should be accounted for under *AASB 116 Property Plant and Equipment and AASB138 Intangible Assets*. For any right of use assets used, the costs of these assets (mainly finance costs and depreciation) should be accounted for under *AASB 16 Leases*. These costs must be included under Total Expense.

2.9.2 The determination of depreciation and amortisation of assets is to be based on the original cost base of the asset. Revaluation of assets is not allowed.

2.9.3 The useful life of the assets in the first year of the EBIT determination must be the same as that used in the audited financial statements for the previous year. These useful lives will be used for any subsequent applications and EBIT determinations unless there has been a change in useful life of assets which has been reflected in the relevant financial year's audited financial statements.

3. Accelerated Depreciation

3.1 Accelerated depreciation may be applied to the calculation of EBIT for a Facility by specifying a depreciation schedule with a depreciation factor of 1.0, 1.1 or 1.2 for each capital expense of the Facility. This is consistent with Subsection 37(5) of the Safeguard Rule. An asset located outside the Facility's NGER boundary cannot apply accelerated depreciation.

3.2 The accelerated depreciation factor used for a given asset is locked in for the period of that TEBA determination. To calculate the accelerated (TEBA) depreciation schedule for an asset, the asset's depreciation value used for normal accounting practices for that year is multiplied by the nominated depreciation factor. An example of this is provided in Box 1.

Box 1. Applying accelerate depreciation to an existing depreciation schedule.

Year	BAU Net book value	TEBA Net book value
0	$100,000	$100,000
1	$82,000	$78,400
2	$46,000	$35,200
3	$28,000	$13,600
4	$10,000	$0

The starting asset value for the TEBA depreciation schedule is the current carrying value of the asset. The BAU depreciation schedule assumes a straight-line depreciation.

$$\frac{[Starting\ asset\ value - salvage\ value]}{Useful\ life} = \frac{\$100{,}000 - \$10{,}000}{5} = \$18{,}000$$

Applying accelerate depreciation utilising a factor of 1.2 is done by multiplying the product of the above formula by 1.2. This results in a yearly depreciation of $21,600.

$$\left(\frac{[Starting\ asset\ value - salvage\ value]}{Useful\ life}\right) \times\ depriciation\ factor\ \left(\frac{\$100{,}000 - \$10{,}000}{5}\right) \times 1.2 = \$21{,}600$$

3.3 A new TEBA application for a determination to commence in a subsequent year would be able to nominate a different accelerated depreciation factor to apply in the new TEBA determination period.

3.4 In setting new depreciation factors and changing previously set depreciation schedules, the responsible emitter must apply the new depreciation factor to the carrying value of the assets which were included in the previous determination. The carrying value of these assets should be the nominal book value of these assets at the start of the new application as if the depreciation factor used in the previous determination applied consistently before the start of the new determination.

Appendix A – EBIT calculation guidance

The below table is a proforma for the purpose of the application. The below information should be appropriately supported and information should be provided to the auditor.

EBIT Element	Amount	Supporting document reference	Reference
Revenue:			
Revenue from external customers			AASB 15
Revenue from internal sources			See section 2
Other revenue:			
Interest income (C)			AASB 9
Grant income			AASB 120
Gain / Loss on sale of Property Plant and equipment			AASB 116
Gain / Loss on foreign exchange transactions			AASB 121
Less revenue outside of NGER boundaries			See section 2
TOTAL REVENUE (A)			
Direct costs incurred:			See section 2
Suppliers			
Salaries and Wages			
Book depreciation and amortisation			AASB 116
Accelerated deprecation included			Section 3
Interest expense (D)			AASB 9
Impairment of assets			AASB 136
Other expenses			
Less costs for revenue that is outside of NGER boundaries			See section 2
Indirect costs incurred:			See section 2
Suppliers			
Salaries and Wages			
Book depreciation and amortisation			AASB 116
Accelerated deprecation included			Section 3
Interest expense (E)			AASB 9
Other expenses			
Other allocated costs			Section 2
TOTAL EXPENSES (B)			
Tax expense / benefit (F)			If tax is not included in the total expenses, this item should be zero.
PROFIT AFTER TAX (G = A-B-F)			AASB 101
EBIT Determination (G+F+E+D-C)			