



Introduction

The impact of the global financial crisis has clearly been front-of-mind for most businesses in recent times. However, we are now seeing a renewed focus on climate change and renewable energy sources, particularly with the US Government's recent commitment to introduce relevant legislation. A number of governments around the world have implemented schemes to reduce carbon emission levels and promote investment in alternative forms of energy, while many others are in the process of introducing new legislation intended to achieve the same objective.

A range of schemes now exists to help to achieve those goals. Emission reduction schemes - designed to reduce greenhouse gas emissions - comprise of tradeable emission allowances or permits. Renewable energy schemes encompass Clean Development Mechanism (CDM) schemes and green certificates. But the assortment of different schemes already in use, or being contemplated, has created a host of new challenges in financial reporting.

In this publication, we explore the accounting issues that arise from these schemes, illustrating some of the different practices that have arisen. This publication does not, however, discuss in any depth the nature of these schemes themselves. Other publications are available on our website that provide more information about climate change issues and sustainability programmes.

Key insights

- ▶ No specific guidance in IFRS or US GAAP
- ▶ Exposure Draft on cap and trade schemes expected late 2009
- ▶ Divergent practices have emerged
- ▶ Accounting policy choices need to be evaluated as the various choices have differing consequences

Emerging trends

- ▶ Cap and trade schemes - three basic approaches applied which may give rise to intangible assets
- ▶ Certified emission reductions - may give rise to intangible assets or inventory
- ▶ Green certificates - may give rise to intangible assets or inventory
- ▶ Broker traders - permits/certificates carried at fair value
- ▶ Proposals for disclosure of information about carbon change risk recently released by the Climate Disclosure Standards Board

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Accounting practices

At present there is no accounting standard or interpretation within International Financial Reporting Standards (IFRS) or United States' Generally Accepted Accounting Principles (US GAAP) that deals specifically with the accounting for emission permits or renewable energy certificates. Entities must therefore apply judgment and determine an accounting method based on the general principles of IFRS. In Europe, where such schemes have been in operation for some time, a number of different accounting approaches have emerged. However, this divergence in practice undermines the comparability of financial statements, making it harder for stakeholders to make appropriate decisions.

We believe it is vital that a standard is developed to provide a framework for climate change accounting and give stakeholders the information they require. Both the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) recognise this need and, to that end, added a joint project to their agenda in December 2007 on accounting for emissions trading schemes. An Exposure Draft is due to be issued in late 2009.

The status of the project at both the IASB and FASB is:

- ▶ May 2008: the Boards tentatively decided that the scope of the project would address the accounting for all tradeable rights and obligations and for activities to receive tradeable rights in the future, e.g., certified emission rights.

- ▶ March 2009: the IASB tentatively decided that permits received free of charge from the government should be recorded as assets at fair value. However, the decision about how to account for the offsetting credit did not prove to be as straightforward. The debate focused on when an obligation arises. Some felt that a liability is created on the day the permits are received. But others felt that a liability only arises in the future as the entity actually emits carbon emissions, and therefore receiving the permits give rise to income. The Board tentatively decided that a liability is recognised at the fair value of the permits received, although this still needs to be reconciled to the IASB's conceptual framework.
- ▶ April 2009: The FASB discussed, but did not reach any conclusions on, the initial recognition and measurement of tradeable permits that are issued to an entity free of charge. The FASB noted the accounting for emission trading schemes involve issues that are also being discussed in the joint conceptual framework project and the IASB's project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and directed the staff to ensure consistent decisions are made.

While we welcome the Boards' decision to pursue this project, we are concerned that the decision to limit the scope of the project to tradeable rights and obligations and activities to receive tradeable rights in the future means that it will not address other schemes that encourage investment in alternative energy, such as green certificates.

Cap and trade schemes

Emission reduction schemes often take the form of a 'cap and trade' model (such as that implemented in Europe), whereby participants are allocated emission permits or allowances that represent allowable amounts of carbon emissions - the cap or target level of emissions. These permits can also be traded. To the extent that an entity emits more than the limits held (corresponding to the permits held), it must buy permits from the market or pay a penalty.

In November 2003, the Emerging Issues Task Force (EITF) in the US attempted to establish guidance and discussed EITF 03-14 *Participants' Accounting for Emissions Allowances under a "Cap and Trade" Program*. EITF 03-14 proposed to adopt a scheme based on the requirements of the Federal Energy Regulatory Commission (FERC). The FERC requires that permits are reported at historical cost - being the amount paid for them - and are classified as inventory. However, the EITF removed EITF 03-14 from its agenda. As a result, no specific US GAAP guidance exists on the topic.

In December 2004, the IASB issued IFRIC 3 *Emission Rights*, to address the accounting for emission permits arising from such schemes. However, the Interpretation met with significant resistance on the basis that it resulted in accounting mismatches between the measurement of assets and liabilities. Consequently, the IASB decided to withdraw the Interpretation in June 2005 - despite the fact that it considered it to be an appropriate interpretation of existing IFRS.



Until definitive guidance on accounting for cap and trade schemes is issued, an entity applying IFRS has the option of either:

- ▶ Applying the principles of IFRIC 3 (despite its withdrawal); or
- ▶ Developing its own accounting policy for cap and trade schemes based on the hierarchy of authoritative guidance in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Management will need to use judgment to develop and apply an accounting policy that is relevant and reliable. In doing so, management should consider the impact that adopting alternative accounting treatments may have on the profit and loss and financial position of the entity.

The IFRIC 3 approach

IFRIC 3 takes the view that a cap and trade scheme gives rise to various items that are to be accounted for separately:

- ▶ An asset for the emission permits received - permits, whether allocated by government or purchased, are intangible assets to be accounted for under IAS 38 *Intangible Assets*. Permits granted for less than fair value are measured initially at their fair value. On a go-forward basis, entities have the choice to carry the intangible asset at cost or at fair value (to the extent that an active market for the permits exists).
- ▶ A government grant - arises when permits are granted for less than fair value and represents the difference between the fair value and the nominal amount paid. The grant is recognised as deferred income and subsequently recognised as income on a systematic basis over the compliance period for which the permits are issued.
- ▶ A liability for the obligation to deliver permits equal to emissions that have been made - as emissions are made, a liability is recognised under IAS 37.

As noted above, the application of IFRIC 3 met with significant resistance on the basis that it resulted in a number of accounting mismatches:

- ▶ A measurement mismatch between the asset and liabilities recognised - if the cost model is applied to value the asset, the liability will be measured at current value, while the asset will not.
- ▶ A mismatch in the location in which the gains or losses on those assets and liabilities are reported - if the fair value model is applied to value the asset, the changes in value will be recognised in equity, while the changes in the value of the liability will be recognised in the income statement.
- ▶ A timing mismatch - as permits would be recognised when they are obtained, typically at the start of the year, whereas the emission liability would be recognised during the year as it is incurred.

Given these mismatches, very few companies subject to such schemes have applied IFRIC 3 on a voluntary basis. Instead, a range of approaches has developed in practice, that can be broadly grouped into either the net liability approach or the government grant approach. In Europe, there has, however, been a strong trend towards the net liability approach.

Net liability approach

Under the net liability approach, emission permits granted are recorded at their nominal amount (i.e., nil if granted for nil consideration) and the entity only recognises a liability once actual emissions exceed the permits granted and still held.

Under this approach, emission permits purchased are accounted for as any other purchased intangible asset.

Government grants approach

Another approach which has gained acceptance is to recognise the emission permits granted by the government initially at their fair value and a corresponding government grant (deferred income) in the balance sheet. The government grant is subsequently recognised in income on a systematic basis over the compliance period for which the permits are issued. To that extent, the approach follows that required by IFRIC 3. However, rather than measuring the liability at the present market price of the permits, the liability is measured by reference to the amounts recorded for the emission permits held as assets that will be used to settle the liability.



Example illustrating the different approaches for accounting for cap and trade schemes

Entity A receives permits on 1 January 2009, representing the right to emit 10,000 tons of carbon emissions for the year ending 31 December 2009. The market price of permits at 1 January 2009 is €10/ton.

The market price of permits and the actual carbon emissions during the year are as follows:

Quarter	Carbon emissions	Market price
Q1	3,000 tons	€10/ton
Q2	3,000 tons	€12/ton
Q3	3,000 tons	€14/ton
Q4	3,000 tons	€16/ton

The impact of the alternative accounting approaches is summarised below:

	IFRIC 3 approach ¹	Net liability approach	Government grant approach
Recognise an asset on 1 January 2009	€100,000 (10,000 x €10)	€0	€100,000 (10,000 x €10)
Q1 balance of liability	€30,000 (3,000 x €10)	€0	€30,000 (3,000 x €10)
Q2 balance of liability	€72,000 (6,000 x €12)	€0	€60,000 (6,000 x €10)
Q3 balance of liability	€126,000 (9,000 x €14)	€0	€90,000 (9,000 x €10)
Q4 balance of liability	€192,000 (12,000 x €16)	€32,000 (2,000 x €16)	€132,000 (10,000 x €10) plus (2,000 x €16)
Total expense for the year	€192,000	€32,000	€132,000
Total income for the year	€100,000	€0	€100,000 ²

¹ Assuming the revaluation model in IAS 38 is not adopted.

² Being amortisation of the grant to the income statement.

Consequences of the accounting method selected

The accounting policy selected for the emission permits has consequences for further activities of an entity, including:

- ▶ Impairment testing of emission permits - when market values decline, there is an indication of impairment. However, the permits will be tested for impairment as part of a larger cash-generating unit.
- ▶ Accounting for the tax treatment of the permits - each jurisdiction has different requirements relating to the tax treatment of permits granted, purchased and/or sold. Nevertheless, the tax treatment often differs from the accounting treatment, giving rise to deferred taxes. Careful assessment is needed of the tax requirements in each jurisdiction.
- ▶ Determining whether there is an active market for the permits - if the permits are recognised as intangible assets, a fair value model may be adopted, but only if there is an active market. In many jurisdictions, particularly in the early years of a scheme, it may be difficult to prove that the market is active.



- ▶ Sales of permits - any sale will require a careful evaluation to determine if sufficient permits are held to match the emissions made. Selling too many permits can inadvertently trigger additional costs, even if the entity intends to purchase permits in the future to cover the emissions liability.
- ▶ Valuation of permits and liabilities as part of a business combination - regardless of the accounting approach adopted for emission permits granted in a business combination, the permits will be accounted for as purchased permits and will need to be recognised at fair value. Similarly, a liability will need to be recognised, but only for the emissions actually made. However, the valuation of the permits and underlying assets needs to be carefully assessed to ensure that there is no double counting of the effect of holding the permits.
- ▶ Identification of which entity is responsible for/has ownership of the emission permits and, therefore, should recognise the liability. Some schemes allow for the transfer of emission permits within a group. Hence, policies will need to be determined to account for such transfers.
- ▶ Accounting for forward contracts to purchase or sell emission permits - such contracts are derivative instruments to be recognised and measured at fair value, unless they are designated as hedges or 'own use contracts' and exempted from IAS 39 *Financial Instruments: Recognition and Measurements*.
- ▶ Accounting for swaps of permits with certified emission reductions (see below) – such contracts are derivative instruments to be recognised and measured at fair value, unless they are designated as 'own use contracts' and exempt from IAS 39.

Broker traders

Broker traders will not be granted permits. Instead they must purchase them from other entities. As such, these will initially be recognised at cost - i.e., the amount paid. As broker traders hold the permits for sale in the ordinary course of business, the permits meet the definition of inventory. Broker traders, therefore, have a choice to account for these at the lower of cost and net realisable value or fair value less costs to sell. If the permits are carried at fair value less costs to sell, all changes in value are recognised in the income statement.

Some entities hold permits for use in their business to offset emissions and they also have a trading department that trades in emission rights. The trading department in these entities essentially act as a broker trader. Such entities will need to split their holdings and apply different accounting practices to each holding.

Renewable energy certificates

The Clean Development Mechanism (CDM) is a mechanism that has been put in place by the Kyoto Protocol to benefit entities that implement projects to reduce greenhouse gas emissions in developing countries. These entities benefit by receiving certified emission reductions (CERs).

To qualify for CERs, CDM projects must meet a number of 'additionality criteria', the minimum being:

- ▶ Reducing emissions below the level that would have occurred in the absence of the project
- ▶ Demonstrating that a project would not have occurred without the additional incentive provided by the emission reduction credit
- ▶ Obtaining certification of actual emission reduction from an independent authority



From an entity's perspective, CERs can be sold or used to meet obligations under emissions trading schemes. CERs have a lower market value than the European emission permits and, hence, tend to be actively sought after by entities affected by Emissions Trading Schemes.

Green certificates, on the other hand, are granted to an electricity generator based on the power output (kWh) derived from renewable energy sources. The generator may then sell these to distributors or retailers, either with the electricity sold, or separately. Distributors or retailers must source a specified portion of energy they sell from renewable sources. Hence, they are required to hand over to the government a relevant number of green certificates (as evidence of renewable sources being used) or pay a penalty.

Similar to cap and trade schemes, there is no specific accounting guidance for CERs or green certificates. However, the permissible accounting treatments are, in principle, similar to those discussed for cap and trade emission permits and are detailed below. Management judgment is required to determine an appropriate accounting policy.

Certified Emission Reductions

CERs meet the definition of government grants and fall within the scope of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. As such, a grant is recognised when there is reasonable assurance that the entity will comply with the conditions attached to it and the grants will be received.

At a minimum, these conditions will only be met when:

- ▶ The actual emission reductions have been realised; and
- ▶ The entity has reasonable assurance these reductions will be confirmed during the verification and certification process by the respective independent authority. This assessment must also take into account any additional terms and conditions that may apply.

In most cases, the grant will be recognised as an intangible asset in accordance with IAS 38. However, it may also be appropriate to recognise CERs as inventory in accordance with IAS 2 *Inventory* if they are held for sale in the ordinary course of business, or to settle an emissions liability in the ordinary course of business.

IAS 20 permits the grant to be measured on initial recognition at either its nominal value or its fair value. As CDM projects only qualify when the additionality criteria have been met, this means the project would not have been economically viable without the incentive of the CERs. If the grant is measured at nominal value, the benefit would only be recognised upon sale or utilisation of the CER, rather than when the benefit was actually received. Hence, we expect that most entities would recognise the CERs at fair value, with revenue recognised in the income statement during the same period as the related costs are recognised. This means that, if the costs incurred have been capitalised as an asset, the fair value of the CER may be deducted from the carrying amount of the asset.

When the CERs are recognised as intangible assets, they are subsequently measured in accordance with IAS 38, using either the cost model or revaluation model if an active market exists.

If an entity applies the cost model under IAS 38, the CERs will not normally be amortised as the benefits are not consumed while the CERs are held, but are realised by either settlement of an existing emission liability or through sale. However, the assets will still need to be assessed for impairment by applying IAS 36 *Impairment of Assets*.

Many of the consequences of the accounting method discussed in the section entitled *Cap and trade schemes* are equally relevant for the accounting method selected for certified emission reductions.

Green certificates

Generator with no distribution activities

While there are varying views as to the exact nature of green certificates, we believe that green certificates granted to a generator by a government body are government grants and also fall within the scope of IAS 20. Accordingly, a grant is recognised when there is reasonable assurance that the entity will comply with the conditions attached to it. This requirement will generally be met once energy is produced. A green certificate is recognised as an intangible asset and can be measured on initial recognition at either its nominal value or its fair value.



As the market for green certificates is usually local (and therefore limited), fair value may be difficult to determine. If the grant is recorded at fair value, it should be recognised as either a reduction in production costs for the period (on the basis that the purpose of the grant is to compensate the producer for the higher cost), or as other income. As electricity cannot be stored, this effectively means that, if it is recognised as a reduction in production costs, it will be expensed in the period electricity is generated.

Subsequent revaluation of the intangible asset is only allowed if an active market exists for the green certificates.

Example of accounting for Certified Emission Reductions

An entity undertakes a project which meets the additionality criteria under the CDM. In the first year after the project is completed, it reduces its emissions and has reasonable assurance that this will be confirmed during the certification process. The entity will receive 10,000 CERs which have a market value of €50,000. Management incurred costs to operate the plant for the year of €250,000 and considers that this is a grant against the costs of operating the plant.

The impact of the alternative accounting approaches is summarised below:

	Fair value approach	Nominal value approach
Asset recognised (either intangible asset or inventory)	€50,000	€0
Grant recognised in income	€50,000	€0
Net costs of operating the plant	€200,000	€250,000

Distributor or retailer with no generation activities

Green certificates may only be purchased by a distributor, either directly from the generator or from the market. They are recognised as intangible assets and measured at cost. Similarly, as electricity is sold, a liability is recognised for the obligation to deliver green certificates to the government. There are, however, a number of alternative ways to account for the asset and liability.

Approach 1: intangible assets may be revalued, but only if there is an active market. The liability is initially measured at the fair value of the certificates to be remitted, with a corresponding expense in cost of sales. The liability is then re-measured at each balance sheet date for the change in the value of the certificates to be delivered. This results in a mismatch between the asset and liability similar to that noted when applying IFRIC 3 to a cap and trade scheme.

Approach 2: classify the green certificates, to the extent that they offset the liability recognised, as a reimbursement right in respect of the liability (rather than as a separate intangible asset). The liability is initially measured at the fair value of the certificates to be remitted, with a corresponding expense in cost of sales. The liability is then re-measured at each balance sheet date for the change in the value of the certificates to be delivered. This would allow the reimbursement right to be re-measured to fair value to match the liability, even where there is no active market.

Approach 3: measure the liability based on the carrying value of the green certificates held. If insufficient certificates are held, the liability in excess of certificates held is measured at the fair value of the certificates the entity must purchase to meet its obligation.

When an entity is both a generator and distributor or retailer

When the distributor is also a producer of renewable energy, it has the option to use certificates granted to it to settle its liability as a distributor, or to sell the certificates in the market. The entity effectively has the same accounting choices that are outlined above for the cap and trade schemes. That is, the entity can apply the requirements of IFRIC 3, the net liability approach, or the government grant approach.

Many of the consequences of the accounting method discussed in the section entitled *Cap and trade* schemes are equally relevant for the accounting method selected for green certificates by both the generator and distributor.



Example of accounting for green certificates

Generator

An electricity generator produces green electricity and receives 15,000 certificates. There is a local market, and the certificates have a market value of €15,000. Management incurred costs of €180,000 producing electricity in the period.

The impact of the alternative accounting approaches for the generator is summarised below:

	Fair value approach	Nominal value approach
Asset recognised as intangible asset	€15,000	€0
Grant recognised in income	€15,000	€0
Net costs of production	€165,000	€180,000

The impact of the alternative accounting approaches for the distributor is summarised below:

	IFRIC 3 approach ³ Approach 1	Reimbursement right approach Approach 2	Asset carrying value approach Approach 3
Recognise an asset on 1 January 2009	€100,000	€100,000	€100,000
Q1 balance of liability	€50,000 (25,000 x €2)	€50,000 (25,000 x €2)	€25,000 (25,000 x €1)
Q1 asset balance	€100,000	€125,000 (25,000 x €2) + (75,000 x €1)	€100,000
Q2 balance of liability	€150,000 (50,000 x €3)	€150,000 (50,000 x €3)	€50,000 (50,000 x €1)
Q2 asset balance	€100,000	€200,000 (50,000 x €3) + (50,000 x €1)	€100,000
Q3 balance of liability	€375,000 (75,000 x €5)	€375,000 (75,000 x €5)	€75,000 (75,000 x €1)
Q3 asset balance	€100,000	€400,000 (75,000 x €5) + (25,000 x €1)	€100,000
Q4 balance of liability	€600,000 (100,000 x €6)	€600,000 (100,000 x €6)	€100,000 (100,000 x €1)
Q4 asset balance	€100,000	€600,000 (100,000 x €6)	€100,000
Total expense for the year	€600,000	€600,000	€100,000
Total income for the year	€0	€500,000 (100,000 kWh revalued from €1 to €6)	€0

³ Assuming the revaluation model in IAS 38 is not adopted.

Distributor

A distributor purchases electricity and green certificates from the generator on 1 January 2009. The price assigned to the certificates is €100,000 which will match 100,000 kWh of electricity sold. The sales of kWh and the market price of the certificates during the year are as follows:

Quarter	kWh sold	Market price
Q1	25,000 kWh	€2/kWh
Q2	25,000 kWh	€3/kWh
Q3	25,000 kWh	€5/kWh
Q4	25,000 kWh	€6/kWh

The Climate Disclosure Standards Board (CDSB) Reporting Framework

CDSB is a consortium of business and environmental organisations formed for the purpose of jointly advocating a generally-accepted international framework for companies to disclose information about climate change-related risks and opportunities, carbon footprints, carbon reduction strategies, and their implications for shareholder value.

The CDSB issued an Exposure Draft of its Reporting Framework for comment in May 2009. Although the CDSB is proposing disclosure of non-financial information, its proposed Framework is aligned with the existing relevant principles and objectives of financial reporting as issued by the IASB, to provide decision-useful information in annual financial reports. These proposals are designed on a principles-based model which aims to find the right balance between rules and principles, thus allowing flexibility for judgment to be exercised by management on those aspects of climate change they consider most likely to affect the economic performance and prospects of their company.

In particular, the proposed framework considers **what** should be disclosed and **how** this information should be reported. The objective is to enable users to identify major trends and significant events related to climate change that affect a company's current or future financial condition. In this respect, the specific objectives of the framework are to elicit disclosures that:

- ▶ Complement and supplement financial statements.
- ▶ Inform investors about management's views of the most important climate change-related issues and the risks affecting the company's performance.
- ▶ Enable investors to assess the strategies adopted to manage those issues and the likelihood of success of those strategies.
- ▶ Follow a common approach that is transparent, consistent and enable comparison between companies.

The Exposure Draft includes reporting templates for:

- ▶ Strategic analysis.
- ▶ Regulatory risks from climate change.
- ▶ Physical risks from climate change.
- ▶ Greenhouse gas (GHG) emissions.

While the Framework is voluntary, it is expected to be influential, so companies should not miss the opportunity to provide their input.

The Exposure Draft is open for comment until 25 September 2009.

Conclusion

Until a final standard is issued by the standard setters, management will have to exercise judgment and select an appropriate method of accounting for emission permits and renewable energy certificates. Regardless of the accounting approach adopted, the need to communicate clearly with stakeholders and other users of the financial report about how the entity's performance and overall company value has been, and will be, affected by the relevant scheme is important.

For more information about climate change matters, please contact your local Ernst & Young professional or one of our Area Climate Change and Sustainability Services leaders.

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