How do you account for emissions or 'green' schemes?

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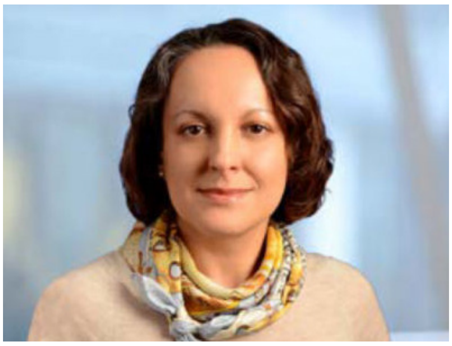

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What's the issue?

Governments around the world are introducing schemes designed to encourage a shift to greener sources of energy and reduce emissions of pollutants. These schemes can vary widely and it is critical that a company understands its rights and obligations under each scheme when determining the accounting.

Considerations include the following.

- What are the terms of the scheme?
- When does an obligation arise – i.e. what is the obligating event?
- Is an outflow of resources probable?
- What is the cost of settling the obligation?
- Do any rights held by the company under the scheme meet the definition of an asset?

Getting into more detail

What are the terms of the scheme?

To determine the appropriate accounting, a company needs to consider the following questions.

- Is the scheme designed to penalise or incentivise? For example, does it penalise companies that pollute, or incentivise companies that use or generate green energy? Some schemes may be designed to both penalise and incentivise – e.g. cap and trade schemes.
- Is the scheme voluntary or mandatory and what is the governing authority? For example, penalty schemes may be set by a government body, whereas incentive schemes may be set by industry bodies.
- What is the company required to do under the scheme? For example, is the company required not to exceed a target (e.g. for CO_2 emissions) or is the company required to meet a target (e.g. for sale of green vehicles)?
- How would an obligation arising under the scheme be settled? Some schemes may require a company to pay a penalty or submit credits. Others may require a company to develop a remediation plan and adjust its operations going forward.
- Can rights obtained under the scheme be sold or traded? If a scheme involves certificates or credits, is there an established exchange or trading platform?

Understanding the key terms of an emissions or green scheme is the critical first step in determining whether you have an obligation and how to measure that obligation.

Generally, the relevant standard for assessing a company's obligation under a scheme is IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* including guidance in IFRIC 21 *Levies.*

And if a company receives rights under the scheme, then it may also need to consider IAS 2 *Inventories*, IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and/or IAS 38 *Intangible Assets*.

When does an obligation arise under a scheme?

Generally, obligations relating to mandatory schemes are triggered by legislation. However, in some cases a company's established practice or external communications may give rise to a constructive obligation – e.g. if a company has committed to purchasing certificates to settle its emission breaches when it has a choice to introduce a future remediation plan instead. *[IAS 37.14(a)]*

Conversely, a company cannot recognise a provision if it intends to make changes to the way it operates going forward – i.e. it cannot provide for future operating losses. *[IAS 37.19, 63]*

Governments may be in the process of implementing new or updating existing legislation in this area. A company reflects the impact of possible new legislation in its financial statements only when it is virtually certain to be enacted as it is drafted. *[IAS 37.22]*

Is an outflow of resources probable?

It may not always be clear whether an outflow of resources is required under a scheme. If no outflow of resources is required, then no provision is recognised. For example, if a company can remedy a breach by reducing future emissions or changing its product mix in the following period, then this would not give rise to a provision because there is no outflow of resources required to settle the obligation. *[IAS 37.14(b)]*

Also, if a scheme does not specify a fixed penalty for not meeting a target and/or there is no established market for trading related certificates, then a company will need to apply judgement to determine whether it can measure an obligation reliably. *[IAS 37.14(c)]*

What is the cost of settling the obligation?

If the terms of the scheme specify the monetary penalty for not meeting a target or the formula to calculate the monetary amount, then measuring the obligation is generally straightforward. *[IAS 37.36]*

However, some schemes may require the company to purchase credits or certificates from other companies – e.g. cap and trade schemes. This can make measurement more challenging, especially if many sales and purchases of credits are private transactions. *[Insights 3.12.510]*

Do any rights held by the company under the scheme meet the definition of an asset?

Companies may obtain rights from the government or another body managing the scheme, such as 'certificates' or 'credits'. In addition to using the certificates or credits to settle its own obligation, the company may be able to sell them to other companies. Some companies may also purchase rights to trade.

Companies need to consider whether these rights meet relevant criteria to be recognised as assets and determine the appropriate standard(s) to apply – i.e. the standard on government grants (IAS 20), inventories (IAS 2) or intangible assets (IAS 38). Measuring these assets can also be difficult if the certificates or credits are not actively traded. *[Insights 3.8.73, 3.3.160, 4.3.110]*

Disclosures

Companies need to provide clear and meaningful disclosures about significant judgements and estimates made in recognising and measuring provisions and assets related to emissions or green schemes.

Actions for management to take now

- Understand the current and potential emissions or green schemes that either apply or could apply to the company.
- Determine when an obligation arises under the scheme and the criteria for recognising a provision are met.
- Assess whether any rights obtained under a scheme, such as certificates or credits, meet the relevant criteria to be recognised as an asset and determine the appropriate standard to apply.
- Provide clear and meaningful disclosures about significant judgements and estimates made in recognising and measuring provisions and assets.

References to 'Insights' mean our publication **Insights into IFRS**

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