IFRS Today

Our series on the most topical issues in IFRS® Accounting Standards and financial reporting

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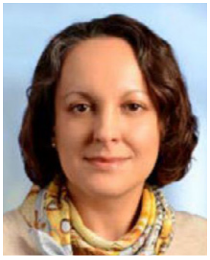

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PODCAST TRANSCRIPT

Emissions schemes | Generating carbon credits under voluntary schemes

James

Hello and welcome to the latest episode of KPMG's emissions podcast series in which we explore emerging trends in emissions and green schemes and the related financial reporting impacts under IFRS Accounting Standards.

I'm joined again today by Irina Ipatova, an associate partner in the International Standards Group, and Allison McManus, a partner in the Canadian firm and member of KPMG's Global Revenue and Provisions Topic Team.

Irina, Allison – In our previous podcast, we outlined some of the key terms and conditions of voluntary green schemes, and how they operate in practice. But today we're going to take it a step further and look at the financial reporting considerations for those companies who generate carbon credits under voluntary green schemes.

Irina

That's right, James. The key challenge is that there are no specific requirements under IFRS Accounting Standards that apply to green schemes.

So companies need to understand the terms and conditions of the schemes and determine which particular existing standards would apply to them. Today, we will highlight some of the considerations that would help to build a framework to make those financial reporting decisions. We're going to talk about three things today.

- First, should carbon credits be recognised separately? And at what amount?
- Second, how do we measure them after they are recognised?
- And last but not least, when do you derecognise them? Allison – Shall we start with the question of whether carbon credits should be recognised separately?

Allison

Absolutely. Now, if a company generates carbon credits by using green inputs as part of its operations or by performing green activities, then the first issue to consider is whether the carbon credits should be separated from those underlying inputs or activities.

This can be challenging and the analysis would depend on the specific terms of the scheme. To help illustrate this, let's think about two scenarios involving sustainable aviation fuel used by airlines. And we discussed some of these scenarios in one of our previous podcasts. In the first scenario, an airline uses a specific amount of sustainable aviation fuel for a flight and then labels that flight as being green. In this case, the carbon credits are not accounted for separately, and the airline will simply recognise a higher cost of providing the flight, which in this case is a service.

In the second scenario, the airline uses sustainable aviation fuel and offers separately the related carbon credits to its customers for a fee. In this case, the carbon credits would be accounted for and recognised separately.

Now, some of you out there might point out that if the carbon credits are in fact transferred to the customer at the same time as the flight that generates them, the accounting outcome in the second scenario may be similar to the first scenario – and you'd be exactly right.

Irina

I agree, Allison. I would also add that in determining whether carbon credits should be accounted for as a separate asset, a company would generally consider how it is going to use them and whether they are expected to generate economic benefits.

For example, the company could sell the carbon credits to another party, or retire them to offset its own emissions and make a statement in its sustainability reporting, or use the carbon credits to settle its own obligation under a mandatory scheme. This ability to use the carbon credits indicates that they could generate economic benefits and do meet the definition of an asset.

This would also affect another matter to consider on initial recognition: the classification of carbon credits as inventory or intangible assets.

James

Okay. And why is the classification so important?

Irina

James, that's fairly simple: because it is a critical step in the framework that will help you determine both the accounting and financial reporting impacts. You need to figure out which IFRS Accounting Standard to apply: the one for inventories or the one for intangible assets.

The carbon credits may meet the definition of inventories if they're held for sale in the ordinary course of business or consumed in the production process. In some cases, they might also be classified as intangible assets: for example, if they are held to offset a company's own emissions. I would note, though, that most companies generating credits do so to sell them. So, we'll focus today on carbon credits that meet the definition of inventory.

James

I see. Thanks, Irina. So, once the company comes to the conclusion that any carbon credits it has generated should be classified and accounted for as inventories, what should the next step be?

Allison

The next question is really when to recognise the carbon credits and at what amount.

And of course this depends on the scheme. If carbon credits are recorded in a specific register for the scheme, then this is often the point at which they are recognised in the accounts of the company. Now, determining the amount to recognise – that is the cost of the carbon credits – may be challenging because carbon credits are often generated together with the underlying service or good.

And so the total cost would need to be allocated between these two things. Various approaches may be applied here. One that I've seen in practice is to use the relative fair value or the relative stand-alone selling price of the underlying good or service and the carbon credits to perform that allocation of cost.

Irina

I agree, Allison. Determining the cost can be a real challenge.

Another interesting case to mention is credits generated from carbon that's captured by trees which are themselves accounted for as biological assets at fair value. Usually that fair value would include an estimate of the future cash flows that could be generated from sales of carbon credits. In this case, it might make sense to measure the carbon credits like agricultural produce.

So, at the fair value less costs to sell when the carbon credits are recognised separately.

James

Yeah. So it does seem that there's a lot to think about when carbon credits are first recognised. It just makes me think what comes next. How do we measure them after they've been recognised?

Allison

Well, this is a little bit more straightforward once the company has determined which IFRS Accounting Standard to apply.

Irina mentioned that we're primarily talking about companies who are applying the inventory standard and, under that standard, the carbon credits would be accounted for at the lower of the cost or net realisable value.

James

I see – Thanks Allison. What about the timings around taking a recognised carbon credit off your books?

Irina

James – The answer may be fairly clear if the carbon credits are sold. That is: the carbon credits would be derecognised when control is transferred to the customer. But if the carbon credits are simply retired by the company to offset its own emissions, which it releases in the production process, then the company may need to carefully consider when the economic benefits from the carbon credits are consumed. I would say typically this would be when the credits are retired and removed from the respective register.

James

Thank you both. It's really helpful to hear you break down the approach of the accounting for carbon credits generated under voluntary schemes. If there was one key takeaway message you would offer listeners, what would that be?

Allison

Well, similar to some of the messages that we gave in the last podcast, understanding all the terms of the schemes is super-critical. But I think here we also layered on a need to understand how the company is going to use the carbon credits because both will be critical to determine the impact on financial reporting.

Irina

I would also add that approaching the analysis in a structured way is important and, as we highlighted today, the framework which we used in this podcast may be helpful to do this. You need to think about the initial recognition, subsequent measurement and disposal. And of course, don't forget about the meaningful disclosures of information that may be relevant to your users.

James

That's great. Thank you both. And I agree, Irina, it really does sound like what you shared today could be used as a framework to help companies work through the analysis of whatever green schemes they're engaged with.

In our next episode, we'll be taking a look at how companies are rising to the financial reporting challenges that come into play when net-zero commitments are made.

But for now, thanks for listening and stay tuned.

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