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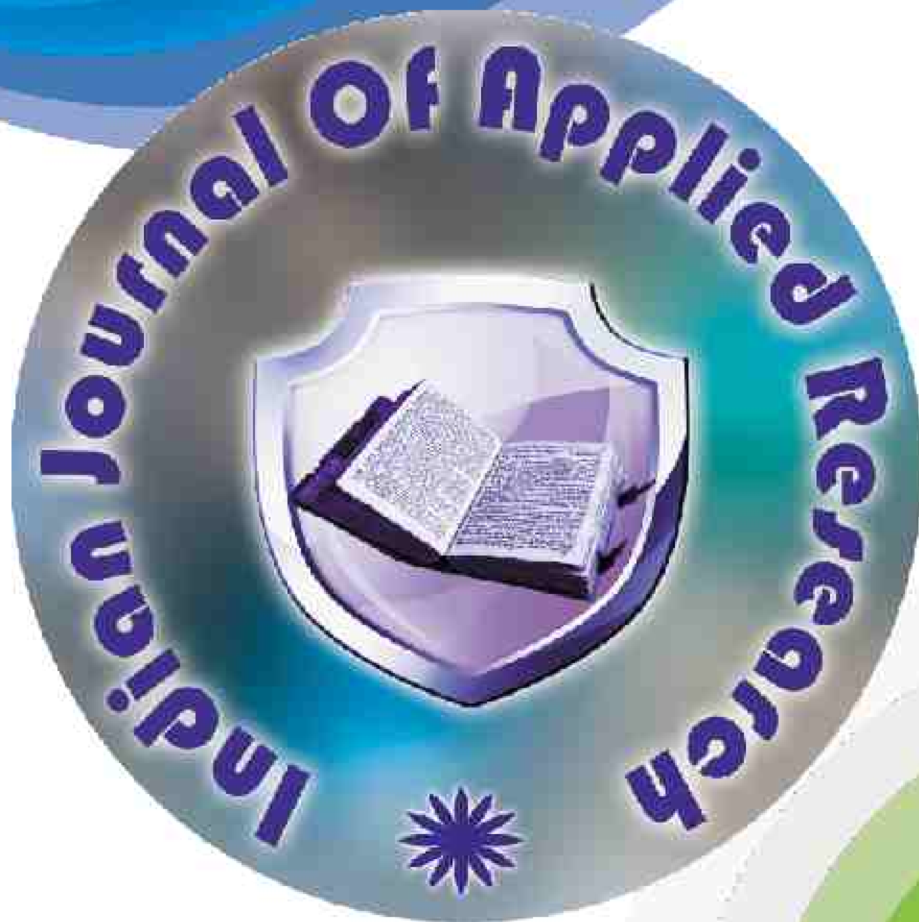

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Research Paper Management

Accounting For Carbon Credits

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ABSTRACT

A number of Indian companies generate carbon credit under the Clean Development Mechanism (CDM). The amount involved is material enough to the overall viability of a project.

Under IFRS, most entities generating CERs treat the same as government grant covered under IAS 20 (Accounting for Government Grants and Disclosure of Government Assistance). This is because an international agency grants the same. Accordingly, based on IAS 20 requirements, a generating entity recognises CERs as asset once there is a reasonable assurance that it will comply with conditions attached and CERs will be received.

Keywords : Carbon Credit, India

Carbon Credits in India

Our earth is undoubtedly warming. This warming is largely the result of emissions of carbon dioxide and other Greenhouse Gases (GHG's) from human activities including industrial processes, fossil fuel combustion, and changes in land use, such as deforestation etc. Addressing climate change is not a simple task. To protect ourselves, our economy, and our land from the adverse effects of climate change, we must reduce emissions of carbon dioxide and other greenhouse gases. To achieve this goal the concept of Clean Development Mechanism (CDM) has come into vogue as a part of Kyoto Protocol.

Indian scenario:

India comes under the third category of signatories to UNFCCC. India signed and ratified the Protocol in August, 2002 and has emerged as a world leader in reduction of greenhouse gases

by adopting Clean Development Mechanisms (CDMs) in the past few years.

According to Report on National Action Plan for operationalising Clean Development Mechanism (CDM) by Planning Commission, Govt. of India, the total CO2-equivalent emissions in 1990 were 10, 01, 352 Gg (Gigagrams), which was approximately 3% of global emissions. If India can capture a 10% share of the global CDM market, annual CER revenues to the country could range from US$ 10 million to 300 million (assuming thatCDM is used to meet 10-50% of the global demand for GHG emission reduction of roughly 1 billion tonnes CO2, and prices range from US$ 3.5-5.5 per tonne of CO2). As the deadline for meeting the

Kyoto Protocol targets draws nearer, prices can be expected to rise, as countries/companies save carbon credits to meet strict targets in the future.

India is well ahead in establishing a full-fledged system in operationalising CDM, through the

Designated National Authority (DNA). Other than Industries and transportation, the major sources of GHG's emission in India are as follows:

- Paddy fields
- Enteric fermentation from cattle and buffaloes
- Municipal Solid Waste

Of the above three sources the emissions from the paddy fields can be reduced through special irrigation strategy and appropriate choice of cultivars; whereas enteric fermentation emission can also be reduced through proper feed management.

In recent days the third source of emission i.e. Municipal Solid Waste Dumping Grounds are emerging as a potential CDM activity despite being provided least attention till date.

Accounting for carbon credits

A number of Indian companies generate carbon credit under the Clean Development Mechanism (CDM). The amount involved is material enough to the overall viability of a project. Under the International Financial Reporting Standards (IFRS), the International Accounting Standards Board (IASB) had issued an interpretation IFRIC 3 (Emission Rights), which was withdrawn in June 2005. Thus, the IASB is still debating on an appropri ate treatment for Carbon Emission Reductions (CERs)

Under IFRS, most entities generating CERs treat the same as government grant covered under IAS 20 (Accounting for Government Grants and Disclosure of Government Assistance). This is because an international agency grants the same. Accordingly, based on IAS 20 requirements, a generating entity recognises CERs as asset once there is a reasonable assurance that it will comply with conditions attached and CERs will be received.

AS 20 gives an option to measure such grants either at fair value or nominal value. Most entities will measure the CERs at fair value to ensure appropriate matching with the costs incurred. They will recognise this in the income statement in the same period as the related cost which the grant is intended to compensate. The corresponding debit will be to intangible assets in accordance with IAS 38 (Intangible Assets).

No guidance is currently available under Indian GAAP (generally accepted accounting principles).

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Consequently, various practices exist (a) income from sale of CERs is recognised upon execution of a firm sale contract for the eligible credits, as prior to that there is no certainty of the amount to be realised; (b) income from CERs is recognised at estimated realisable value on their confirmation by the authorities concerned; and (c) income from CER is recognised on an entitlement basis based on reasonable certainty after making adjustments for expected deductions.

The Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) has issued an Exposure Draft (ED) of the Guidance Note on Accounting for Self-generated Certified Emission Reductions. The ED proposes to lay down the manner of applying accounting principles to CERs generated by an entity.

According to the ED, the generating entity should recognise CERs as asset only after receipt of communication for credit from United Nations Framework for Climate Change (UNFCCC) and provided it is probable that future benefits associated with CERs will flow to the entity and costs to generate CERs can be measured reliably.

Further, such assets meet the definition of the term 'inventory' given under AS 2 (Valuation of Inventories) and, hence, are valued at lower cost and net realisable value.

Only the costs incurred for the certification of CERs bring the CERs into existence and, therefore, only those costs should be included in the cost of inventory. According to the prescribed criteria, all other costs are either not directly relevant in bringing the inventory to its present location and condition or they are incurred before CERs come into existence . Thus, those costs cannot be inventorised. The ED will result in significant cost and revenue mismatch in the financial statements. This is because entities would need to expense most of their costs as soon as incurred (with an insignificant amount being capitalised as inventory), but will recognise revenue arising from CERs only when these are actually sold.

Clearly, the accounting recommended by the ICAI is very different from existing practices under Indian GAAP and, hence, every company that has significant revenue from carbon credits will have to consider the impact of the ED carefully.

Key accounting considerations

In relation to accounting for the CERs, there is no definitive accounting literature prescribed under the Indian GAAP. The Institute of Chartered Accountants of India (ICAI) has issued an exposure draft on accounting for self-generated Certified Emission Reductions in June 2009. As per the exposure draft, the following needs to be evaluated while accounting for CERs:

1. Is CER an asset?

An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. CER can be treated as an asset when

the communication of credit of CER is received by the generating entity since only at this stage the CER becomes a resource controlled by the generating entity and therefore leads to expected future economic benefits in the form of cash and cash equivalent which would arise on the future sale of CER.

2. Can CER be treated as an asset prior to communication of credit of CER is received by the generating entity?

CER cannot be treated as an asset prior to the communication of credit of CER is received by the generating entity, since there is no resource in existence for the generating entity and hence the question of 'resource controlled' and 'expected future economic benefits' does not arise.

3. When should a CER be recognised as an asset in the financial statements?

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it are expected to flow to the enterprise and the asset has a cost or value that can be measured reliably. Since the market for CERs is relatively new, the future economic benefits may not always be assured. The entity needs to make an assessment of the probabilitiy of the future economic benefits and if benefits are considered to be probable because there is a market for the self generated CERs, CERs should be recognised. Further, there are certain costs which are incurred to generate CERs, and therefore the cost of CERs can be measured reliably (see detailed discussion later).

4. What type of asset is a CER i.e. is it a tangible asset or an intangible asset?

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Further, the intangible asset also includes assets which are development by an entity for sale. CERs are treated as intangible assets since they are non-monetary assets without a physical form held for sale.

5. Are CERs within the scope of AS 26 Intangible Assets?

AS 26 scopes out those intangible assets from its purview which are specifically dealt with in another Accounting Standard and require them to be accounted for in accordance with that Standard. For instance, intangible assets held for the purpose of sale in the ordinary course of business are excluded from the scope of AS 26 and are to be accounted for as per AS 2,

Valuation of Inventories.

Inventories are assets:

(a) held for sale in the ordinary course of business

(b) in the process of production for such Sale

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

CERs are inventories of the generating entity as they are generated and held for the purpose of sale in the ordinary course of business. Even though, CERs are intangible assets, they are not within the scope of AS 26 and hence need to be accounted for as per the requirements of AS 2.

6. How should the CER be measured?

CERs should be measured at cost or net realisable value, whichever is lower. Cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. Various costs are incurred by

the generating entity to set up a CDM project activity, operate the CDM project and generate CERs. However, not all costs incurred by the generating entity give rise to CERs and therefore not all costs can be considered as the cost of bringing CERs into existence.

The cost incurred by the generating entity and the accounting treatment has been explained in the below table:

[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	

[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	
[illegible]	
[illegible]	
[illegible]	[illegible]

The net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

While determining the net realizable value of CERs, one of the most reliable evidence available at the time the estimates must be considered, for example exchange quoted price. The estimated must take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date

7. How should the underlying assets related to CERs be measured?

In case the entities use tangible assets for pollution control/reduction of emission such as incinerators, such assets are recorded as per the AS 10 Fixed Assets. Further, in case these assets generate CERs, the depreciation shall not be included in the cost of the inventory of the principal product of the generating entity as they do not contribute to bringing the inventory of the principal product to their present location and condition

For example, if an entity in a chemical business installs incinerators to reduce emissions, the depreciation of the incinerators should not be added in the cost of producing chemicals. Further, the depreciation of these devices should also not be included in the cost of inventory of CERs as the depreciation is incurred at the stage before CERs come into existence. Also

as discussed in the preceding question, only costs incurred towards the certification are the costs of the inventory of CERs as they bring the CERs into existence. Accordingly, depreciation of the pollution control/emission reduction devices should be expensed in the period to which it relates.

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