



Accounting for carbon



BDO Stoy Hayward

Accounting for carbon – an industry spawned but is enough understood about how to account for it all?

A company's carbon footprint is of increasing interest to its stakeholders. As the climate change debate moves into the boardroom, more and more companies are looking to develop and implement an emission reduction strategy either as a result of stakeholder expectation or regulation. The languages of the European Union Emission Trading Scheme (EU ETS) and Clean Development Mechanism of the Kyoto Protocol are ones that we are all going to need to become increasingly familiar with.

Specialist companies have emerged which procure emission reduction certificates using a variety of means including simple purchase agreements, direct investment in energy projects and more complex trading arrangements. The market is a global one with large amounts of investment flowing from developed to developing countries. Other companies who generate carbon emissions are involved, either as a result of legislation or voluntarily as part of a voluntary reduction scheme or trading strategy. The latter becoming increasingly popular in the United States – the world's largest greenhouse gas emitter, which so far has not ratified the Kyoto Protocol. In the UK, in addition to the EU ETS, certain electricity suppliers and renewable generators fall within the scope of the Renewables Obligation, a scheme that requires licensed electricity suppliers to source an increasing amount of electricity from renewable sources or pay a penalty.

Many emission reduction strategies involve some form of emission reduction certificate: a relatively new type of 'asset' that companies can buy and sell. In common with other traded assets there are risks that come with acquisition

and ownership of these instruments, such as delivery risk (risk that the obligation to deliver certificates can't be fulfilled) and price risk (risk of an adverse shift in the forward price curve for certificates), that market participants are exposed to. Companies may seek to protect themselves against these risks by adopting some form of hedging strategy. All of this needs to be accounted for.

Transactions undertaken in carbon can fall within the scope of IAS 39 'Financial Instruments: Recognition and Measurement'. IAS 39 is a complex accounting standard which can lead to significant differences in the amounts recognised in a company's financial statements for what, at least on the face of it, are simple transactions. Without understanding the detailed requirements of IAS 39, a company runs the risk of not being in control of the accounting outcomes of carbon related transactions.

To hedge or not to hedge?

Many companies will seek to commercially hedge their emission reduction certificate delivery obligations. A common way to hedge against market price volatility and

delivery risk is to buy certificates forward at a fixed price. What appears at face value to be a relatively straightforward transaction can, however, fall within the scope of IAS 39, meaning that the contract is carried at fair value with market movements being recognised in the income statement (the fair value of the fixed price contract will change as current and anticipated future market prices move). This introduces volatility into the income statement which may not have been contemplated at the outset.

It may be possible to account for the contract as a hedge under IAS 39 which has the effect of removing some or all of the volatility from the income statement. Hedge accounting is difficult to achieve and the record keeping requirements are themselves onerous.

Own use exemption

There is some relief from IAS 39 though. Where the contract is for delivery of emission reduction certificates in accordance with expected usage requirements (and where a company is engaged in the business of acquiring and taking delivery of emission credits for supply to carbon producers) this will in certain circumstances exclude the contract from the scope of IAS 39.

The availability of the own use exemption is extremely sensitive to the pattern of transactions within a portfolio and must be closely monitored and tightly controlled. Any change away from 'expected usage' will normally result in a requirement to apply fair value accounting to instruments previously recognised at cost. The extent to which market movements in the value of purchase

contracts affect the income statement will depend on the interpretation of the underlying contract terms. The recent announcement of Trading Emission plc's 30 June 2007 results includes a £175m fair value gain in respect of financial assets and liabilities. This gain arose directly from the revaluation of the group's carbon credit receivables previously accounted for at cost.

Onerous contracts

Companies which qualify for the 'own use exemption' will still need to consider whether purchase and sale commitments are onerous under the requirements of IAS 37. This means financial statements will always recognise downside in a contract portfolio (as an onerous contract provision) but not necessarily the upside (as there will be no mark to market of the 'own use' portfolio). Long term purchase and supply arrangements are common which can mean that onerous contract provisions are significant when measured at the balance sheet date.

More exotic management of carbon risk

There are a whole host of instruments available to companies to allow them to hedge for the types of uncertainties described above. Banks and intermediaries are becoming increasingly innovative but the accounting impact of each new type of product needs to be analysed carefully to assess its effect on the financial statements. Features written into contracts, such as a variable volume clause, are increasingly common and should be carefully considered. A variable volume clause introduces

optionality which may need to be separately accounted for at fair value with changes in value recorded in profit or loss.

Trading and own use – the importance of a permanent separation

Both carbon intermediaries and industrial companies will buy carbon instruments to meet their own needs, but may also operate speculatively. Clear separation of these portfolios is important from an accounting perspective. Failure to achieve accounting separation can lead to all of an organisation's carbon business being recognised at fair value, removing the own use relief and introducing volatility into the income statement.

The issue of portfolio separation is not new. Energy companies accounting under US GAAP faced some of these issues several years ago and found that there were practical implications of maintaining an own use portfolio. US Energy companies with both energy trading operations and traditional physical business had to adopt policies and procedures to achieve the necessary business separation between their 'trading' and 'physical' businesses to manage and deal with the different accounting outcomes. The same considerations apply for companies accounting under IFRS.

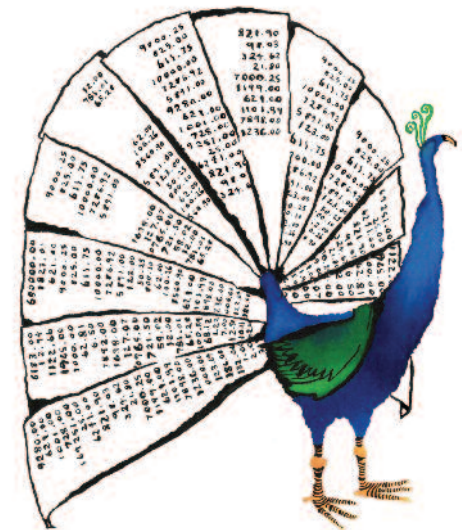
Free issue carbon and the accounting – ending the 'free for all'

There are a host of other issues associated with accounting for emission reduction certificates. These include how to account for free issue, such as the receipt of emission rights certificates granted by an issuing body such as EU Allowances, Certified Emission Reduction

Certificates and Renewable Obligation Certificates. There is also the question of whether an emission reduction certificate is an intangible asset or inventory. Under IFRS, there is currently no authoritative guidance in this area (IFRIC 3 'Emission Rights' was withdrawn after its issue). As a result, there is considerable diversity in practice. The IASB's project to consider accounting for emission rights was re-activated in December 2007.

In summary – look out for the trip wires

Companies involved with any aspect of accounting for carbon need to be aware of the accounting outcomes of both their commercial and trading activities in this area. These are almost always more complex than it would first appear and could lead to some surprises. Best advice is to prepare properly by reviewing the accounting for all carbon reduction activities well in advance.



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Brent Goldman on 020 7893 2243, email brent.goldman@bdo.co.uk (Transaction Services)

Michael Ware on 020 7893 3354, email michael.ware@bdo.co.uk (Project Finance: advisory)

Paula Jennings on 020 7893 3115, email paul.jennings@bdo.co.uk (Project Finance: financial modelling)

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