Accounting and Taxation Aspects of Carbon Trading

The emergence of the opportunity of revenue generation by taking up structured Clean Development Mechanism (CDM) projects has given a new dimension to Accounting and Taxation. As the concept of Carbon Trading is totally new, even at the international level, there are some issues to be settled before arriving at a common opinion. This article takes an in-depth view of the concept.

The Kyoto Protocol, which came into force and became legally binding on 15th February 2005 when Russia ratified the treaty, demands a 5.2% cut in greenhouse gas emissions from the industrialised world as a whole by 2012. India, along with China and Brazil, has emerged as one of its largest beneficiaries in terms of new source of revenue. This is due to Clean Development Mechanism (CDM), which is perhaps most exciting feature of the total scheme which allows 'Annex 1 countries' (A total of 36 countries are listed in Annex 1) to meet their emission reduction targets by paying for greenhouse gas emission reduction in non-Annex 1 (developing) countries.

Most Annex 1 countries have legally binding greenhouse gas emission reduction requirements under the Kyoto Protocol. These countries, instead of reducing emissions of their own companies, can 'buy' emission reductions in non-Annex 1 countries. Article 12 of the Kyoto Protocol states: "The purpose of the Clean Development Mechanism shall be to assist Parties not included in Annex 1 in achieving sustainable development and in contributing to the ultimate objective of the convention, and to assist Parties included in Annex 1 in achieving compliance with their quantified emission limitation and reduction commitments."

India, being a non-Annex 1 country, is naturally one of largest beneficiaries of the Kyoto Protocol. Studies by Crisil and CII estimate the value of the Indian CDM market at more than a billion dollars per annum.

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Trading of Carbon Credits: Trading of carbon credits happens in the form of CERs or Certified Emissions Reductions. CERs are in the form of certificates, just like a stock. A CER is given by the CDM Executive Board to projects in developing countries to certify that they have reduced greenhouse gas emissions by one tonne of carbon dioxide per year. For example, if a project generates energy using wind power instead of burning coal, and in the process saves (say) 25 tonnes of carbon dioxide per year, it can claim 25 CERs (One CER is equivalent to one tonne of carbon dioxide reduced).

CDM Executive Board: A board comprising 10 members supervises the operation of CDM. The Board has the final say on whether a project is approved or not, and lays out procedures and guidelines for CDM.

Verification: A CDM project is monitored or 'verified' after the project has been approved or registered by the CDM Executive Board. After the project is registered by the Executive Board, the Designated Operational Entity (DOE) periodically checks (usually once a year) whether emission reduction has actually taken place or not. It is only after verification by the DOE that CERs are delivered. There are presently 11 DOEs globally, out of which five are represented in India.

Emergence of CER Credits: In March 2006, the United Nations Framework Convention on Climate Change (UNFCCC) CDM Registry

Administrator, for the first time, forwarded CERs to the holding account of a project participant representing a milestone in the implementation of the Kyoto Protocol's CDM. The forwarding of CERs to the holding accounts of project participants provides them with the end product of their efforts to reduce emissions of greenhouse gases in developing countries. These CERs have a ready market, where transactions happen on arm's-length basis and price quoted fluctuate as per the situation of demand and supply, and also according to the negotiation skills of the two parties.

Financial Accounting Issues of CDM Credits in India

India is one of the major players in the global market on the supply side of CERs. Indian companies have started getting credit of CERs and some of them have also entered into sale arrangement with buyers in the international market. As this is a new concept, it has given rise to interesting financial accounting dimensions. Issues involved are (i) how to account for expenditure on CDM projects, (ii) whether or not to account for self-generated CERs held with registry, (iii) if credits are to be accounted, at what point of time these should be recognised in books of accounts and at what value, and (iv) how to account for sale consideration of CERs and its disclosure in accounts and notes. Answers to these questions are found within existing pronouncements of ICAI as well as Schedule VI requirements. Taxation issues will naturally follow.

CDM is a Journey, not a Destination: Developing a CDM project should not be viewed as a commercial transaction. It is not a huge business but simply a profitable way of making business environmentally conscious. A CDM project cannot be undertaken only on the basis of generation of expected CERs points and its market value. To be sustainable, the project must be financially sound by itself. There are several benefits of undertaking CDM projects, starting from reduced energy bills by using energy-efficient equipment, additional depreciation on capital equipments installed for CDM projects, reduced regulatory oversight, image of a responsible corporate citizen, advance preparation for such time when India will be given targets to reduce greenhouse gas emissions on its own account, and so on.

The availability of a mechanism of recognition of carbon credits and its marketability provides additional revenues, and makes businesses more competitive in the global market. As of now, there are no separate Indian accounting standards to measure income and expenditure from carbon reducing projects. The existing standards can well account for new capital investments, its depreciation, recurring costs and sale proceeds of CERs. Some experts feel that CDM projects should be accounted for as a separate segment under AS-17 (segment reporting). This line of thought does not appear practical if the concept of 'journey, not destination' is properly followed. A CDM project cannot be a profit centre or cost centre in itself. In a multi-segment industry, any CDM project can be identified with its parent segment.

CERs are Goods: CER credits are considered goods, as they have all the attributes thereof. As held by the apex court in *TATA Consultancy Services v. State of Andhra Pradesh [2004] 141 Taxman 132/ 271 ITR 401*, while dealing with issue of levy of sales tax on computer software, "a 'goods' may be a tangible property or an intangible one. It would become goods provided it has the attributes thereof having regard to (a) its utility; (b) capability of being bought and

sold; and (c) capability of being transmitted, transferred, delivered, stored and possessed." This approach was reiterated by the apex court in *BSNL v. UOI [2006] 152 Taxman 135/ 282 ITR 273/ 145 STC 1*.

CER Sale is Other Income, Not Turnover: We can safely conclude from the discussion above that sale proceeds of CER credits cannot be included in Turnover. Section 43A(11) of the Companies Act, 1956, defines 'Turnover' as "the aggregate value of the realisation made from the sale, supply or distribution of goods or on account of services rendered, or both". Part II of Schedule VI to the Companies Act, 1956, requires a separate disclosure of "profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount".

Though CERs are goods, their sale is undertaken, if not in exceptional circumstances, certainly on non-recurring basis. We have already seen that a CDM project cannot be a profit/cost centre in itself, and, therefore, it is neither possible nor desirable to attempt to work out separate profit or loss of any CDM project, with an accuracy expected from accountants. A combined reading of Section 43A and Schedule VI of the Companies Act clearly establishes that sale proceeds of CERs should be disclosed as a line item in schedule of other income, if amount is material.

Revenue Recognition on Sale of CER Credits: As we have already concluded that CER credits are goods, their sales proceeds have to be recognised in financial accounts as per para.11 of the Accounting Standard 9 ('revenue recognition'). The conditions of para.11 are self-explanatory, and are reproduced below:

"11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."

Self-generated CERs Held with Registry: Self-generated CERs held with registry cannot be included in Inventories as defined in Accounting Standard-2, as they are not held for sale in the ordinary course of business. On the other hand, such credits meet all the criteria of 'Intangible Asset' as defined in Accounting Standard-26 i.e. (i) identifiability, (ii) control over a resource, and (iii) expectation of future economic benefits flowing to the enterprise.

Para 19 to 23 of Accounting Standard-26 deal with recognition and initial measurement of an intangible asset. Para 20, which is the operating portion of this section, provides that an intangible asset should be recognised if, and only if:

(a) it is probable that future economic benefits attributable to the asset will flow to the enterprise; and

(b) the cost of asset can be measured reliably.

Since we have already demonstrated that availability of CER credits is only an additional benefit of a CDM project, it would be impossible to measure the cost of self-generated CER asset reliably. Thus it can be concluded that though self-generated CERs held with registry are Assets (Intangible), they cannot be recognised in Accounts due to specific requirements of Accounting Standard-26.

Accounting Carbon Credits as per AS-12: Some experts, having admitted that there are presently no guidelines/standards for accounting of Carbon Credits, have suggested that they be accounted as Government Grant. There logic is based on the definition of the term 'Government' prescribed in para 3.1 of AS-12, which reads: "Government refers to government, government agencies and similar bodies,

whether local, national or international." The logic forwarded appears to be misplaced, as in case of financial transactions arising out of carbon credit, monetary consideration will not flow from any government or government agency. In total gambit, UNFCC CDM registry acts as a Demat banker recognising CER credits and keeping an account of it. There is no grant at all from any agency. Further, as soon as Carbon Credits are accounted as Government Grants, Accounting Standard-9 'revenue recognition' will cease to operate, leading to other accounting and taxation complications.

Tax Planning

CER credits are indeed intangible assets, held with registry. CER credits acquired from other parties for the purposes of trading are recognised in the books at the cost of acquisition, whereas self-generated CER credits are not reflected in financial accounts. As issues for accounting of CER credits will appear for the first time in Financial Year 2006-07, it's important to disclose the accounting policy adopted for this purpose. It would be appropriate to disclose units of CER held with registry in notes bi-furcating between purchased and self-generated.

As CERs are capital assets, tax liability should be admitted under the head Capital Gain, and claim for concessional rate of taxation should also be made if credit is held for more than 36 months immediately preceding the date of transfer. This gives an opportunity to take a decision about timings of sale of such credits, keeping a balance between cash flow needs, interest factor and difference in rate of tax between long-term and short-term holdings. As there would be no cost of acquisition for self-generated CER credits, section 55(2) of the Income Tax Act will come into operation, and total sale consideration will be liable for Capital Gains Tax (long term/short term) according to the period of holding.

In Indian circumstances, if sale of CER credits happen to overseas buyers, of the property held overseas, such sale, though sale of 'goods', will not attract any sales tax.

Conclusion

As the issues for accounting of CER credits will appear for the first time in FY 2006-07, it will generate a fair amount of debate among accountancy professionals. ICAI may come up with some guidelines in due course. The views of taxation authorities would be another interesting dimension. This write-up may serve as a starting point for such discussions and debates. ❐