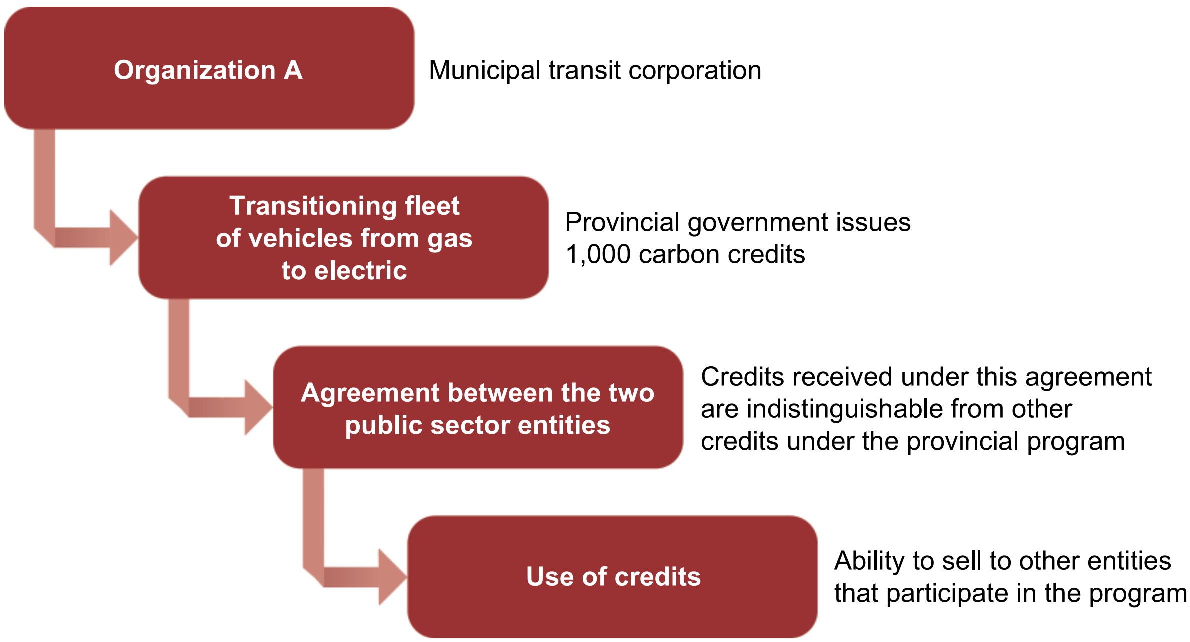
Sections PS 1000 and PS 3210: Can a public sector entity recognize an asset for carbon credits?

Extract, PSA Discussion Group Report on the Public Meeting – November 10, 2022

The submission asked the Group to consider how carbon credits may meet definition of an asset as provided for in Section PS 1000,[1] *Financial Statement Concepts*, and Section PS 3210, *Assets*.



The submission presented the following scenario and asked the Group whether definition of an asset is met and, if so, whether disclosure is required under the standards:

- Organization A has no compliance obligations. So, it has no need to use the credits and it intends to sell them on the market within three months of receipt.
- Carbon credits can be traded in the provincially regulated markets through brokers to other participants in the program. The provincial government must approve transactions in the credits.
- The provincial government does not recognize a financial liability for carbon credits in the consolidated provincial accounts.
- Organization A has publicly stated it intends to sell any carbon credits obtained and to reinvest proceeds in green initiatives in the municipality.

[1] Material that links to the CPA Canada Handbook is available to subscribers only. However, all information needed to respond is provided in this meeting report.

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- Organization A’s Internal policy sets out how and when the credits will be exchanged in the market.
- Transactions to sell the credits are assumed to be material.

Issue 1 – Do carbon credits meet the definition of an asset under Sections PS 1000 and PS 3210?

The Group was asked to consider whether carbon credits meet the definition of an asset (View A) or not (View B).

Most Group members supported View A, indicating that the asset definition is met because:

- Control over the carbon credits exists. This assumes the province would approve transactions in the credits. If approval was unlikely, then the province would not issue them and the market for such credits would be undermined. Past practice indicates that the province is unlikely to intervene in a transaction.
- Further, control exists since the organization can decide:
  - to sell the cardon credits;
  - to hold the cardon credits; and
  - to whom they wish to sell the credits.
- The province’s involvement is an administrative exercise and Organization A maintains control.
- The ability to sell the carbon credits is established. Selling the credits in an active market will result in future economic benefits.
- Organization A’s transitioning its vehicle fleet from gas to electric earned it the credits and this comprises the past event that created the asset.

A few Group members noted that View B had merit because of uncertainties relating to provincial approval and thus Organization A’s control of the future economic benefits associated with the credits:

- The province may deny future transactions to sell the credits. Although the province has not done so in the past, circumstances may change, and the province could deny or re-assess transactions. Provincial changes in policies frequently occur. Ministerial discretion to approve or not is likely retained regardless of past practice.
- The key provincial objective of issuing carbon credits is to support green initiatives. Some Group members felt the province’s agreement on such transactions may be contingent on the proceeds of sale being used for green initiatives. Without such restrictions, there is a risk that the credits would be just another funding source, a form of government transfer. And if the sale proceeds are not used for green initiatives, there is some potential for provincial claw back.
- A change in provincial government could also affect the market for and issuance of carbon credits. At a minimum, an entity should assess the likelihood of provincial approval on a regular basis, similar to the assessment done for allowances for doubtful accounts.

Issue 2 – What kind of asset are the carbon credits under public sector accounting standards (PSAS)?

For discussing Issue 2, the Group assumed the credits meet the definition of an asset for Organization A.

If the carbon credits meet the definition of an asset, Organization A needs to consider what kind of asset the carbon credits represent before determining what recognition and measurement guidance applies to those assets.

Carbon credits are part of a market that allows polluters either to pay for credits or to invest in reducing carbon emissions. At some point, it will become uneconomical for polluters to buy credits rather than invest, especially if the province increases the costs of carbon credits or increases the requirements around carbon emissions. These factors could affect an organization's ability to sell carbon credits.

The following types of assets were identified for Group members to consider:

Financial Assets	Non-financial Assets
1. Inventory for resale	1. Inventories held for consumption or use
2. Assets held for sale	2. Prepayment
3. Other financial asset	3. Intangible asset

In considering the nature of the asset, some Group members referred to the definition of an intangible asset in *Purchased Intangibles*, paragraphs PSG-8.6-7, and to the definition of a financial asset in paragraph PS 1000.40. Group members were also asked to consider if their answer would change if Organization A's intent was to use the credits rather than sell them.

Specifically, if Organization A held the credits for its own use rather than for sale (i.e., to offset against an emissions obligation that Organization A has incurred), would the credits still be a financial asset? Assume that the mechanism for cash conversion exists (a marketplace) even if it is not the entity's intent to convert the credits into cash, but to monetize them by using them to reduce a liability.

Ultimately, most Group members indicated some support for classifying the carbon credits as an "other" type of financial asset, but also acknowledged that the intent of the entity holding the credits would affect asset classification. Classification as inventory was somewhat problematic, as in most cases the credits would not form part of an entity's core operations. If designated as an "other" type of asset held for sale, the burden of proof that the credits are truly designated for sale required by Section PS 1201, *Financial Statement Presentation*, would come into play. And, only purchased intangibles can be recognized in financial statements. There is some question whether the credits issued by the province to Organization A can be considered "purchased." The classification of such credits has implications for the net debt indicator, too, depending on whether they are classified as financial assets or non-financial assets. So, the classification of such credits and whether they should form part of the net debt calculation are also considerations.

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In reaching these conclusions, Group members shared the following points:

- If the credits are to be resold, they are more likely to meet the definition of a financial asset,[2] than the definition of an intangible asset. However, some Group members noted that if there is no intent to resell the credits, they may better meet the definition of an intangible asset.[3]
- Carbon credits should be classified as inventory for resale or another asset for sale as allowed in Section PS 1201, if there is an intent to sell. Intent is relevant to determining classification:
  - If the organization intends to sell and convert the credits to cash, then the intent as to timing of sale may be relevant. If the intent is to sell within one year and the requirements of Section PS 1201 are met, then it may be a (financial) asset for sale. If intent is to hold the credits for longer than a year and possibly sell later, then some kind of "other financial asset" classification may be appropriate.
  - If the intent is to use the credits, they are not really an inventory for use in the same way as gravel, parts, or other supplies. They lack the physical substance traditionally associated with inventory. The entity cannot readily replenish the "stock" of carbon credits. And the Organization A's core business or operations is not to hold and trade such credits.
- Credits would be a short-term investment recognized as an asset on the assumption that there is an open market for the credits and that the province does not limit who purchasers can be.
- It is important to assess and interpret each situation, including:
  - the intended use of the credits;
  - any contractual obligations and definitions affecting use of the credits, including provincial restrictions or regulations; and
  - whether the credits constitute a prepayment if the entity intends to use them itself, or not a prepayment, if the entity intends to sell them and there is an ability to resell the credits.

Many Group members noted that fact patterns are likely to determine the type of asset. Individual carbon-credit arrangements would need to be reviewed in determining an appropriate approach. For example:

- One Group member noted the similarity to fishing licenses, which are recognized as intangible assets as they are held for the use by the organization, similar to carbon credits. While carbon credits lack physical substance, if the intent is to sell them, they are better classified as a financial asset.
- If the credits are held for the entity's own use rather than for sale, they remain a realizable asset that is convertible into cash and should be classified as a financial asset. If the entity retains a contractual right to sell the credits in the future, could the credits give rise to a new type of financial instrument?

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[2] Paragraph PS 1000.39 defines financial assets as "assets that could be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of operations."

[3] PSG-8, paragraph 1, defines purchased intangibles as: "identifiable non-monetary economic resources without physical substance acquired through an arm's length exchange transaction between knowledgeable, willing parties who are under no compulsion to act." Only purchased intangibles can be recognized in financial statements per the PSA Handbook (paragraph PS 1000.57)

- One Group member noted that paragraph 2 of PSG-8 would scope out the credits being classified as an intangible asset because they are in the nature of a contribution or transfer from the province.[4] Other Group members felt the carbon credits are intangible in nature. One questioned whether intangibles held for sale could be classified as a financial asset.

Issue 3 – What recognition standards apply to the carbon credits?

The Group was asked to consider three views:

- View A: Carbon credits are an intangible asset that is not recognized under PSAS.
- View B: Carbon credits are a financial asset and therefore can be recognized under PSAS, regardless of their intangible nature.
- View C: Carbon credits are an intangible asset that can be recognized under PSAS.

The Group agreed the answers to Issues, 1, 2, and 3 should be consistent, and View B would most closely achieve this objective. Nevertheless, Organization A's intent for the carbon credits remained a factor.

The Group was asked to consider paragraph PS 1000.58 qualifying the prohibition of intangibles by allowing only recognition of purchased intangibles.[5] Developed or "non-purchased" intangibles specifically cannot be recognized. "Granted" or "earned" intangibles are not mentioned, but these could fit under "non-purchased".

The Group concluded that the carbon credits, as defined in the submission's fact patterns, would not meet the definition of a purchased intangible asset. So, View A was not possible under existing generally accepted accounting principles (GAAP), though it held appeal for some Group members. They raised a concern that View A might make the credits invisible assets to users and thus be misleading. If View A were adopted, some Group members indicated that disclosure would be necessary to partially mitigate this concern. One Group member expressed the view that recognition prohibitions prevent public sector entities from dealing with new items. The Group encouraged PSAB to consider intangibles more broadly and carbon credits specifically should it initiate a project on intangibles.

Some Group members raised the liability question, noting that if an organization does not meet government-imposed emission targets or other metrics, there may be a liability to be recognized.

Issue 4 asked about the impact of receiving carbon credits from a related party. The Group thought it overlapped with the points discussed for the other three issues and deferred it for possible future consideration as practice develops on accounting for carbon credits.

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[4] Paragraph 2 of PSG-8: Intangibles acquired through a transfer, contribution or inter-entity transaction, are not purchased intangibles.

[5] Paragraph PS 1000.58: *"In the absence of appropriate public sector recognition and measurement criteria* for intangibles, all intangibles, including those that have been purchased developed construction or inherited in right of the crown, are not recognized as asset in government financial statements." [italics added for emphasis].