Carbon pricing models

Talking points for episode 122

The Paris Agreement adopted at COP 21 in 2015 introduced a market based mechanism to price carbon with the aim of cost-effectively managing and reducing global greenhouse gas emissions.

Compliance schemes generally work on the 'cap and trade' principle, where a cap is set on the total amount of emissions and companies are incentivised to reduce emissions through the requirement to submit certificates each year to cover their emissions. Accounting for compliance schemes was discussed in more detail in IFRS Talks episode 100. Further information is also available in the recently released PwC and IETA publication *Emissions trading systems: the opportunities ahead* and a 2021 survey of carbon market participants.

Voluntary schemes also exist:

- reduction schemes cut emissions by preventing emissions or improving processes - for example introducing more efficient cooking stoves, developing renewable projects, etc.
- removal projects directly absorb or eliminate greenhouse gases that can be offset against emissions. They're either nature-based – re-forestation for example – or technology-based, such as carbon capture and storage solutions.

The accounting for voluntary schemes has created challenges and may differ, depending on perspective:

- Investors that capitalise assets used in a removal (or 'offset') program will need to consider the nature of the assets, which could be regarded as a prepayment, a financial instrument, inventory, or as an investment in property, plant, and equipment or as inventory.
- Subject, to further developments in accounting standards, purchasers of carbon offsets may account for them as (1) inventory (if held for use or sale) or (2) an intangible asset (if held for use).
- Broker-traders might account for carbon offsets as inventory at cost or fair value, depending on the liquidity of the market.
- Common practice is to expense the offset in P&L at the point of use. But there are challenges in determining when a carbon offset is retired, ie 'used', creating a significant risk of greenwashing and double-counting.

Companies need to be transparent about their approach to carbon emissions, with significant focus on non-financial reporting. It is important that there is consistency between the non-financial reporting information about matters related to carbon emissions and the assumptions used in financial statements, and that this consistency is evident in disclosures.

Further developments in the accounting for carbon pricing mechanisms might arise following the IASB's Agenda Consultation, where it is clear that many see projects on climate-related risks as high priority.

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