

30 July 2010

**GOVERNMENT FINANCIAL REPORTING
MANUAL (FReM) EXPOSURE DRAFT No:**

(10)04

EXPOSURE DRAFT OF PROPOSED
AMENDMENTS TO THE FReM

**Accounting for the
CRC Energy Efficiency Scheme**

Comments to be received by 24 September 2010



HM TREASURY

ASSURANCE AND FINANCIAL REPORTING POLICY TEAM HM TREASURY

This exposure draft of proposed amendments to the Government Financial Reporting Manual (FReM) is published by HM Treasury for comment only. The proposals may be modified in the light of comments received in this consultation process before being presented to the Financial Reporting Advisory Board for its approval. Final proposals approved by the Financial Reporting Advisory Board will be published as amendments to the FReM from the proposed effective date.

Comments on this exposure draft should be submitted in writing so as to be received by **24 September 2010**. Respondents are asked to send their comments electronically to FReM.consultation@hmtreasury.gsi.gov.uk.

All responses will be published on the FReM website unless the respondent requests confidentiality.



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Proposed amendments to the FReM

Introduction

The Assurance and Financial Reporting Policy team, HM Treasury, has published this exposure draft of proposed amendments to the Government Financial Reporting Manual (FReM) as part of its ongoing work in ensuring that the Manual reflects the latest developments in government financial reporting.

Structure of exposure draft

The exposure draft includes a section for each FReM chapter for which an amendment is proposed. Each section includes:

- (a) An explanation of why the amendment is proposed.
- (b) When necessary, any specific additional question unique to that proposed amendment;
- (c) The paragraphs of the FReM chapter that are affected by the proposed amendment;
- (d) The proposed effective date of each proposed amendment.

Invitation to comment

HM Treasury invites comments on the proposed amendments. It would particularly welcome answers to the questions set out below. Comments are most helpful if they:

- (a) Answer the question as stated;
- (b) Indicate the specific paragraph or paragraphs to which they relate;
- (c) Contain a clear rationale; and
- (d) Describe any alternative HM Treasury should consider.

HM Treasury will consider all comments received in writing by 24 September 2010. In considering the comments, HM Treasury will base its conclusions on the merits of the arguments for and against each alternative, not on the number of responses supporting each alternative.

Accounting for the CRC Energy Efficiency Scheme	
Why the amendment is proposed	Reporting entities participating in the CRC Energy Efficiency Scheme will need to account for assets, liabilities, expenses and income related to the scheme.
Paragraph(s) affected by the amendment	New paragraphs 7.2.12 to 7.2.17
Proposed date	2011-12

Background

1. The passing of the Climate Change Act in November 2008 provided enabling powers for the Government to introduce the CRC Energy Efficiency Scheme (CRC). The CRC is a new mandatory emissions trading scheme that aims to reduce carbon dioxide (CO₂) emissions through energy efficiency. Under the CRC, organisations are required to purchase allowances sufficient to cover their CO₂ emissions. The revenue raised from selling allowances will subsequently be ‘recycled’ to participants, with the level of income received by a participant determined by its relative position in a carbon reduction performance league table.

2. CRC will impact on Government departments and the Devolved Administrations, which are regarded as ‘mandated participants’, and also on other reporting entities within the public sector that meet the scheme’s qualifying criteria. The registration period for the introductory phase of the CRC ends on 30 September 2010.

3. Reporting entities covered by the CRC will need to purchase allowances sufficient to cover estimated carbon emissions during 2011-12, the first year of operation. Allowances for 2011-12 will be available for purchase during April 2011, at a price of £12 per tonne of CO₂. They may be purchased at a later date through a safety valve mechanism or a secondary market. The CRC will not become a ‘cap and trade scheme’ until April 2013, although allowances will be traded before then.

4. When reporting entities covered by the scheme produce carbon emissions, this will give rise to a liability, which will be discharged by the surrender of allowances.

5. Reporting entities will receive income in respect of recycled CRC allowances. The amount of income receivable is related to the entity’s performance relative to other organisations in reducing carbon emissions. Income is not directly related to the purchase of allowances, or a reporting entity’s carbon emissions.

6. The Environment Agency is responsible for administering the CRC, and full details of the scheme are available on its website at www.environment-agency.gov.uk/crc.

7. This Exposure Draft provides proposals for accounting for the CRC scheme in resource and other accounts, for those entities falling within the scope of the FReM.

Accounting for the CRC

8. Reporting entities covered by the scheme will be required to account for their CRC allowances from 1 April 2011.

Assets

9. Purchased allowances are recognised as an asset. Allowances are re-valued where required.

10. A key decision to be made in accounting for CRC scheme allowances is whether the allowances should be classified as current assets or intangible assets. The FReM paragraphs 7.2.8 to 7.2.11 already provides guidance on the EU Greenhouse Gas Emission Allowance Trading Directive. This states that ‘Allowances intended to be held for use on a continuing basis should be classified as intangible assets. If not, they should be classified as current assets, within current asset investments.’

11. The IASB is considering this issue, and is expecting to publish an Exposure Draft in the final quarter of 2010, followed by a new IFRS in the final quarter of 2011. At this stage, no decision has been taken as to whether a current or intangible asset should be recognised for CRC allowances.

12. The intention of the CRC scheme is that allowances are purchased in April to cover the emissions of the participating entity during that financial year. By the end of the financial year, the liability to surrender the allowances will have been established. This suggests that generally the appropriate treatment would be to classify allowances as current assets unless they were being purchased with a specific intention to hold them for a period of more than twelve months.

13. The proposed FReM amendment is phrased in terms of allowances being current assets unless there is an intention to hold the asset for more than twelve months. However, HM Treasury would welcome views on this area, which is very much an area of ongoing debate.

14. HM Treasury, in conjunction with CIPFA, have ensured that both the FReM Exposure Draft and the Local Authority Code Exposure Draft on this topic cover the key issues on the same basis.

Liabilities, expenses and income from recycled allowances

15. A liability to deliver allowances and an expense are recognised as energy is consumed. The liability will usually be measured at the present market price of the number of allowances required to cover emissions made up to the reporting date.

16. Reporting entities will receive income from recycled allowances. This income is based on an entity’s emissions in the base year (2010-11) adjusted for the reporting entity’s subsequent performance relative to other scheme participants. A reporting entity need not have purchased allowances from the pool in order to receive income from recycled allowances. HM Treasury has concluded that there is therefore no direct link between a reporting entity’s purchase of allowances or carbon emissions

and the income to be received. As a result, a reporting entity shall recognise income from recycled allowances as it becomes receivable rather than accruing for the income based on its performance in the year.

Summary and Proposal

17. It is proposed to amend the FReM as reporting entities participating in the CRC Energy Efficiency Scheme will need to account for assets, liabilities, expenses and income related to the scheme. Accounting for carbon reduction commitment allowances will be required from 1 April 2011.

18. A key decision to be made is whether the allowances should be classified as current assets or intangible assets. The proposed FReM amendment is phrased in terms of allowances being current assets unless there is an intention to hold the asset for more than twelve months. However, we would welcome views on this area, which is very much subject to ongoing debate.

19. Under the scheme, a liability to deliver allowances and an expense are recognised as energy is consumed. The liability will usually be measured at the present market price of the number of allowances required to cover emissions made up to the reporting date.

20. There is no direct link between a reporting entity's purchase of allowances or carbon emissions and the income to be received. As a result, it is proposed that income from recycled allowances is recognised as it becomes receivable, rather than accruing for the income based on its performance in the year.

General questions (applicable to all proposed amendments)

Question 1

Do you agree with HM Treasury's proposal to amend the FReM as described in the exposure draft? If not, why not, and what alternative do you propose?

Question 2

Do you agree with the proposed effective date? If not, why not, and what alternative do you propose?

Specific questions

Question 3

Should allowances be recognised as current assets or as intangible assets? Please provide reasons in support of your answer.

Question 4

Do you agree that a liability and an expense should be recognised as energy is consumed? If not, why not? What alternatives would you suggest?

Question 5

Do you agree that income from recycled allowances should be recognised as it becomes receivable? If not, why not? What alternatives would you suggest?

FReM chapters addressed

The following table shows the topics addressed by these proposed amendments.

FReM Chapter	Subject of amendment
Chapter 7	Paragraphs 7.2.12 to 7.2.17 have been added to provide accounting for the CRC Energy Efficiency Scheme.

Proposed amendment to:

Government Financial Reporting Manual Chapter *Intangible non-current assets*

Introduction

An amendment to Chapter 7 *Intangible non-current assets* is proposed.

Why the amendment is proposed

Reporting entities participating in the CRC Energy Efficiency Scheme will need to account for assets, liabilities, expenses and income related to the scheme.

Proposed amendment:

New sub-heading and paragraph (new text is underlined):

CRC Energy Efficiency Scheme

Allowances and Emissions

7.2.12 Reporting entities shall recognise an asset for CRC allowances purchased. Allowances shall be recognised as current assets unless they are intended to be held for more than twelve months, when they shall be classified as intangible assets. The asset, whether classified as current or intangible, shall be measured initially at cost. Allowances that are issued for less than their fair value shall be measured initially at their fair value, with the difference between fair value and the purchase price recognised as income.

7.2.13 Assets in respect of allowances shall be revalued in accordance with the relevant chapters of the FReM.

7.2.14 As energy is used, a liability and an expense shall be recognised for the obligation to deliver allowances equal to the actual carbon emissions that have been made. This liability is a provision that falls within the scope of Chapter 10 of the FReM and IAS 37. The liability is discharged by using allowances to meet the liability. The liability and expense shall be measured at the best estimate of the expenditure required to settle the present obligation at the reporting period date. This will usually be the present market price of the number of allowances required to cover emissions made up to the reporting period date.

Income from Recycled Allowances

7.2.15 Income from the sale of allowances is recycled to reporting entities covered by the CRC scheme, based on a reporting entity's emissions in the base year (2010-11) adjusted for the reporting entity's subsequent performance relative to other scheme participants. A reporting entity need not have purchased allowances from the pool in order to receive income from recycled allowances. There is therefore, no direct link between a reporting entity's purchase of allowances or carbon emissions and the income to be received, and a reporting entity shall recognise income from recycled allowances as it becomes receivable.

Penalties

7.2.16 Penalties may be imposed under the CRC scheme for a number of reasons:

- a. Where a reporting entity has misreported its carbon usage by more than 5%;
- b. Where a reporting entity has submitted reports after the due date;
- c. Where a reporting entity covered by the CRC scheme has failed to register for the scheme;
- d. Where a reporting entity has submitted an incomplete evidence pack.

7.2.17 Where a reporting entity considers that it may be subject to a penalty, it shall recognise a provision for that penalty. The penalty shall be measured at the reporting entity's best estimate of the amount to be paid.

Effective date of the amendment

The effective date of the proposed amendment is 1 April 2011.