

Understanding financial reporting for green and stimulus incentives



About this paper

Worldwide efforts to reduce greenhouse gas emissions, spur domestic adoption of cleaner energy sources, and stimulate infrastructure, research, and other business investments have led governments to create and expand tax incentives for renewable energy, provide start-up capital for green industries, and offer energy rebates for upgrading to more efficient plant and equipment. These initiatives can have a significant impact on operations, project funding, investment strategies, and financial reporting.

This paper provides a framework within which to assess certain financial reporting implications that occur when taking advantage of these incentives. More information on the topics included in this paper can be found on the US Sustainability and Climate Change site on www.pwc.com.

Background

To meet greenhouse gas emissions targets set by the Kyoto Protocol and other agreements, governments worldwide are implementing initiatives to develop so-called green technologies. These programs, while they take many forms, generally provide participating companies with “green credits” (i.e., tax incentives, credits, and rebates) for amounts spent that qualify under the various programs. Historically, these incentives have included programs related to research and development, alternative fuels, renewable energy, conformity with Energy Star or other government energy-efficiency standards, and emissions allowances.

At the same time, the global economic downturn has precipitated efforts by governments to stimulate economic activity. Some of these programs are also deployed via tax credits, incentives, or rebates, designed to foster infrastructure, research, and other targeted business investment.

Although green credits and fiscal stimulus incentives are not new, the difficulty in utilizing or otherwise converting such items into cash (i.e., monetizing them) has lessened their impact and utility. But new, more expansive, legislation has led to tax laws increasingly providing for the transferability or refundability of these incentives and credits. In addition, in the United States, we have seen increased activity involving structured transactions, such as a partnership flip[†] and sale-leaseback transactions. These transactions provide companies a way to monetize the incentives and credits.

In the United States, President Obama signed into law The American Recovery and Reinvestment Act of 2009 (the Act) on February 17, 2009. As part of this Act, several new programs are being implemented, primarily related to renewable energy and infrastructure spending through tax credit bonds, such as the Build America Bonds. The Act includes options that allow companies in the renewable energy sector (e.g., wind, solar, biomass) to convert certain tax subsidies on qualifying projects into cash.

The Act significantly broadens the number of companies that are eligible to benefit from these programs. The companies include those in the manufacturing, utilities and energy, technology, financial services, and forest product industries. The full extent of the Act’s provisions is still being analyzed and interpreted, and many companies are looking for opportunities to qualify for some of the programs and tax incentives that have been introduced.

Outside the United States, governments in France and Ireland have provided increased incentives for research, including refundable tax credits. The government of Brazil has enabled companies with income tax losses to apply the losses against value added tax obligations.

[†] Typically, these are tax partnerships between a developer and equity investors whereby the investors are allocated the majority of the tax benefits for a specified period of time.

Accounting overview

The accounting for various credits and incentives may seem counterintuitive at first. While they generally arise in the tax laws and may be claimed on an income tax return, a number of features can make the credits more equivalent to a government grant or subsidy. Companies must therefore analyze each credit to determine its accounting.

Two threshold options for the accounting for credits and incentives are available: (1) the credit falls within the scope of ASC 740, *Income Taxes*, and is accounted for in determining income tax expense or (2) the benefit does not fall within ASC 740 and is accounted for in determining pre-tax income. Even in the latter case, however, the accounting may not always be the same.

Several questions must be considered when undertaking this analysis:

- Is there a direct relationship between the benefit received and taxable income or the income tax liability otherwise due?
- How is the benefit claimed?
- If there is more than one manner in which the benefit may be obtained, is the election irrevocable?
- Can the benefit be sold?
- Is the benefit refundable? For example, if a benefit claimed on an income tax return exceeded tax otherwise due (including as a result of a subsequent loss carryback), would the benefit nonetheless be refundable?
- Is the benefit taxable? Does taxability depend upon the manner in which the benefit is obtained?

These questions are designed to help determine which accounting model is most appropriate for recognition of the benefit. For many of these new or recently modified tax credits and incentives, the realization of the economic benefit does not depend on the existence of taxable income and therefore ASC 740 is not applicable.

Accounting framework

When analyzing the accounting for credits and incentives, companies must first ask whether the credit or incentive is within the scope of ASC 740. The determining factor about whether a particular credit or incentive is within the scope of ASC 740 is how the benefit is received and whether there is any connection to income tax liability. The application of income tax accounting is generally warranted if a particular credit or incentive can be claimed only on the income tax return and can be realized only through the existence of taxable income.

For example, as part of the Act, the Treasury was authorized to award \$2.3 billion in tax credits for qualified investments in advanced energy projects to support new, expanded, or re-equipped domestic manufacturing facilities (i.e., Advanced Energy Manufacturing Credit or AEMC). This credit provides a 30 percent investment credit for qualified property used in an advanced energy manufacturing project. Some of the highlights of this credit include:

- The basis of the qualified property must be reduced by the amount of the credit received.
- The tax credit is not transferrable and is available only to taxpayers that entered into an agreement with the IRS, provided all other requirements have been met.
- The tax credit may be used only to offset income taxes owed, and there are no features that would make this refundable.
- Any unused credits may be carried back one year and carried forward 20 years.

We believe the AEMC should be accounted for as an income tax credit, because it can be received only through the income tax return and it is dependent on taxable income. When accounting for the AEMC, companies should follow the model used to account for investment tax credits (ITCs).

Another example where the accounting follows an income tax model is the recently authorized tax credit Build America Bonds. These are bonds issued by state and local authorities (to finance targeted stimulus infrastructure) which include transferable federal income tax credits. The tax credits can be sold by the holder of the bond until the tax credit is earned. However, after the tax credit is earned it no longer can be sold and it is not refundable. Therefore, the tax credit can only be realized through the income tax return and it is dependent on taxable income and should be accounted for under ASC 740.

Alternatively, several credits (such as the French and Irish R&D credits, the federal alternative fuels credit, renewable energy investment tax credit (REITC) or cash grants in lieu of REITCs) are, or can be, refundable in nature. The accounting for these is different than for credits where ASC 740 applies. Where there is no connection to income taxes payable or taxable income and where the credits are refundable, we believe the benefit should be accounted for under an income recognition model.

Where the credits and incentives are accounted for in determining pre-tax income, a variety of possible income recognition models may apply, depending on the specific attributes of the benefit.

Refundability—does the method of monetization change the accounting?

In some cases, companies have a number of options to monetize the benefits of credits and incentives. For example, with the alternative fuels credit, the benefit can be claimed as an income tax credit, as a reduction in excise tax payments, or as a cash grant. Similarly, the REITC can be claimed as an income tax credit or as a cash grant (i.e., a grant in-lieu of REITCs). Generally, we believe that, regardless of the method a company chooses to monetize the benefit, if there is no connection to income taxes, the accounting would be outside the scope of ASC 740.

There may, however, be some exceptions to this general analysis. For example, if the method of monetizing the benefits could result in significantly different taxation of the benefit, it may be that the method of monetizing will impact the accounting for these benefits.

Taxability of the benefit

In certain situations, the benefit received under these programs may be taxable and the taxability might vary depending on the manner chosen to obtain the benefit. This may impact a company's analysis of the accounting treatment of a particular credit or incentive. For example, a state may or may not tax the benefit, depending on the method chosen to claim the benefit (e.g., taxable if claimed as a grant or nontaxable if claimed as an ITC). In this regard, it is also important to understand whether the company's choice is irrevocable. If so, it would seem that the taxability could produce a different accounting answer. Here we believe that if a company needs to choose to receive the benefit in a certain way (e.g., as a tax credit) to avoid taxation, the appropriate accounting could be to include it in determining income tax expense (ASC 740).

The question of taxability or uncertainty regarding taxability must also be considered even if the benefit is recorded outside the income tax accounts. While an income recognition model may be applied, if there is uncertainty with regard to taxability, this must be analyzed under the provisions of ASC 740, with any unrecognized tax benefits appropriately recorded in income taxes.

Income recognition model

Companies can follow several possible pre-tax income recognition models, depending on the facts and circumstances of the credit or incentive. One model is grant accounting. US GAAP does not provide specific

guidance for grant accounting. As a result, most companies analogize to the International Financial Reporting Standard IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*.

Under IAS 20, the grant can generally be recognized in one of two ways: (1) by reflecting the grant as deferred income on the balance sheet or (2) by deducting the grant from the book basis of the property. Application of IAS 20 may result in various accounting alternatives, depending on specific facts and circumstances. In either case, the company recognizes the benefit over the useful life of the property.

We believe the REITC discussed above, for example, would be accounted for using grant accounting. By analogy, a government grant or subsidy is essentially being provided to the taxpayer through these credits.

In other cases a grant model may not be applicable. For example, in the case of the alternative fuels credit, companies may account for this credit using an income recognition or cost reduction model. Federal tax law is used to provide companies with incentive to utilize alternative fuels in the United States. We believe the related benefit follows an income recognition model versus an income tax accounting model. However, there is diversity in practice as to how these benefits are reflected under the income recognition model. Some companies record the credit or benefit in revenue, cost of sales, or other income/expense in the income statement. Companies should apply judgment to determine the appropriate income statement classification. We believe this decision should be consistently applied and disclosed.

In cases where companies record the credit as a reduction of cost of sales, it would be useful to financial statement users for the company to provide enhanced disclosures that describe the effect on gross margin in the current period and expectations for the future. If the credit is material, those disclosures should be sufficient to provide financial statement users with a full understanding of the nature and amount of the credit.

Other income recognition considerations

In some instances, there may be uncertainty as to the amount the government will ultimately refund. In these cases, companies need to make their best estimate of what they expect to realize and record that amount in their financial statements. Ultimately, the amount of the benefit that a company records should be based on the guidance found in the relevant pre-tax recognition and measurement guidance.

When should the benefit be recognized?

FASB Concept Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, defines revenue as being recognizable when realized or realizable and earned. In analogizing to this definition for income recognition of cash payments received from tax credits, management needs to assess when the company has satisfied all criteria for receiving the cash payment. This includes making required filings with the appropriate governmental authority and performing all actions required to claim the credit. Similarly, with a grant, we expect that a company would record the benefit only after all conditions to receive the grant have been met.

In the case of the AEMC, an application process is required. The government is expected to notify taxpayers in April 2010 of the amount and approval of their grant. In this case we believe this is similar to a change in tax status or a tax accounting method change under ASC 740, where approval is required before the benefit is reflected in the financial statements.

Other tax accounting considerations

Although the benefit of an incentive may be accounted for in determining pre-tax income, there may still be important tax accounting considerations, such as accounting for deferred taxes and uncertain tax positions. For example, in connection with the REITC, there is a requirement to reduce the basis of the property for tax purposes by 50 percent of the benefit. As a result of this basis reduction and the company’s choice of accounting under grant accounting, a book/tax basis difference in the property may arise. Another example where a book/tax basis difference arises is with respect to the AEMC. In the case of the AEMC, there would be a book/tax basis difference for the entire amount of the credit even though the credit itself is recorded in income taxes. We expect these differences would be accounted for under ASC 740, similar to any other book/tax basis difference.

In the event that a reporting entity accounts for the benefits received under the Act as ITCs, it should follow its existing accounting policy consistent with the guidance in ASC 740-10-25-20. That is, either include the benefit to income in the tax computation during the period the benefit is generated or defer and amortize the benefit over the life of the related property.

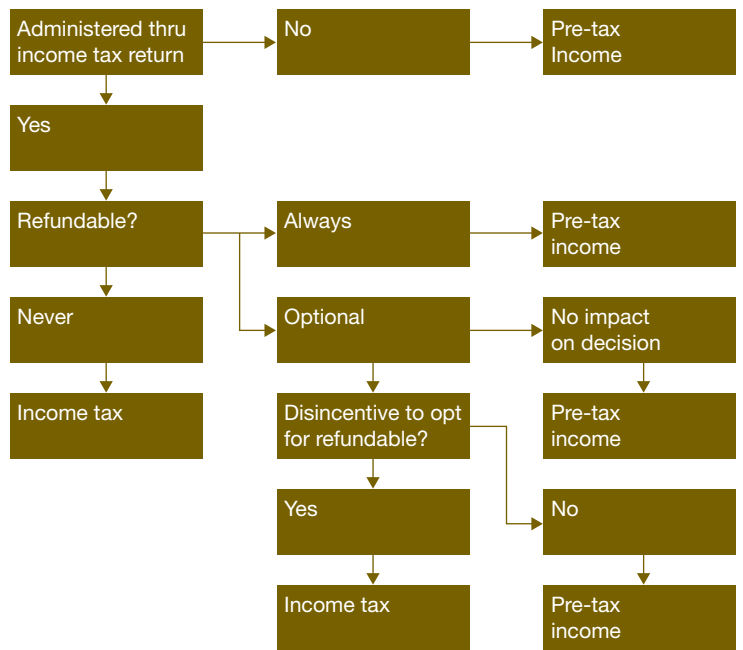
There are two acceptable approaches to provide for deferred income taxes on the book and tax basis differences created on initial recognition of the ITC: (1) the recognition of

deferred taxes, determined through a simultaneous equation that generates a corresponding adjustment in the book basis of the related fixed asset; or (2) an immediate adjustment to income tax expense. This decision is also considered an accounting policy election that should be consistently applied and disclosed.

Companies should be aware of several other considerations when accounting for income tax credits. For instance, when a tax law change impacts the accounting model for these credits and incentives, it may be appropriate for the credits and incentives generated before the tax law change to continue to be accounted for following the accounting model used before the tax law changed. Any credits generated after the tax law change should be accounted for under the accounting model that would now apply. Furthermore, companies should ensure that appropriate valuation allowance considerations are made for any deferred tax assets recorded for these credits and incentives.

Accounting framework—decision tree

The following diagram may be helpful in identifying questions to ask when analyzing which accounting model to apply:



In summary

The accounting for the myriad of credits and incentives existing today requires thoughtful analysis and a solid understanding of the details of the incentive. While these benefits are often introduced through the tax codes in different jurisdictions, this may have the least amount of influence among the factors used in determining the appropriate accounting.

We expect a significant increase in the number of credits, incentives, and other programs available to companies globally, which will likely cause many accounting challenges. To effectively manage these challenges, companies should look to the principles of the accounting framework to help them choose financial reporting methods that are appropriate when accounting for credits and incentives.

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