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# Accounting Considerations for Environmental Objectives

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## Introduction

Are environmental, social, and governance (ESG) matters in the news these days? Yes, indeed! And companies know that ESG matters not only have become a fixture in mainstream and social media but also have become top-of-mind for investors, credit rating agencies, lenders, regulators, policy makers, and other interested parties.

In addition to developing environmental goals, companies are increasing their focus on the accounting and reporting considerations related to both the goals themselves and any transactions they will pursue to achieve those goals. This *Heads Up* takes a strategic look at some of the most common accounting and reporting considerations associated with climate-related matters in the current business environment along with relevant SEC developments.

## SEC Activities Related to Environmental Matters

While the SEC is widely expected to provide updated reporting requirements regarding climate-related topics in the next several months, it has also publicly announced that it will increase its focus on climate-related disclosures when reviewing public company filings. In a manner consistent with this directive, the SEC has recently issued comments to several public companies in a variety of industries.

On September 22, 2021, the SEC publicly released a [sample letter](#) that highlights the types of comments it may issue to public companies regarding climate-related disclosures. A recurring theme of the SEC comments is to ask what considerations companies gave to their environmental goals and related activities (which are typically communicated outside of the financial statements) for SEC reporting purposes (e.g., the business, MD&A, risk factors, and results of operations sections in SEC filings).

For more information about recent SEC communications regarding climate-related matters, see Deloitte's September 27, 2021, [Heads Up](#).

## Plans to Reduce Carbon Footprint

From a big-picture perspective, in most instances, companies will not be able to reduce their carbon footprint without taking action. Environmental objectives and financial reporting should be thought of together, rather than each topic considered in its own separate silo. By viewing them in tandem, companies will be better able to assess the potential implications of their actions on liabilities, assets, and disclosures related to environmental matters.

For instance, does the mere existence of an announcement or plan to reduce carbon emissions or achieve a certain target (e.g., carbon neutral by 2030) require a company to record a liability in its financial statements or have other impacts on the company's financial statements or disclosures? *No, not necessarily.*

A company needs to carefully assess whether any of its activities — including announcements made, information provided in a sustainability report, and plans to reduce its carbon footprint — create a liability to be recorded currently or have other impacts on its financial statements and disclosures. To do so, the company must understand the specific public statements made and determine the details of any plans and actions intended to support those statements.

Below are some of the issues that companies should consider. For a more detailed discussion, see Deloitte's September 30, 2021, [Financial Reporting Alert](#).

## Liabilities

In simplified terms, a liability is a present obligation that exists as of the financial statement date and requires the transfer of resources to another party. Careful consideration should be given to (1) the point in time at which the entity's obligation begins and (2) whether the obligation exists as of the financial statement date. Liabilities arise as a result of a past event; therefore, it is important to consider the obligating event for a liability and when that obligating event occurs. Likewise, it is also important to determine whether any liabilities result from a reciprocal transaction whereby one party exchanges a good or service with another party.

For instance, as employees render services to a company, the company incurs a liability to pay them; the rendering of services in exchange for payment is an example of a reciprocal transaction. The company would not incur a liability to pay for the employees' services before the employees provided them. Similarly, a company may intend to purchase a new environmentally friendly manufacturing facility but would not incur a liability until a contractual obligation exists and the manufacturing facility has been transferred to the company.

However, obligations arising as a result of a government action or a company's climate-related public statements, plans, or actions may not be reciprocal transactions. And assessing the point in time at which the company has incurred a liability that is *not* the result of a reciprocal transaction may require significant judgment. For example, if a company incurs an obligation as a result of future carbon emissions, the obligation may not have existed as of the financial statement date.

Companies should evaluate the existence of legal obligations on the basis of current laws, regulations, contractual obligations, and related interpretations; they should not forecast changes in laws or in the interpretations of such laws and regulations. The impacts of any changes in laws or regulations should be considered in the period in which the new or amended laws or regulations are enacted.

## Assets

As is the case with the considerations noted above regarding liabilities, understanding how a company shifts its business to support its environmental goals or targets is critical to evaluating the ongoing use and recoverability of its long-lived assets, including goodwill, as well as other indefinite-lived intangible assets; property, plant, and equipment; inventory; deferred tax assets; and lease assets. On the basis of these business shifts, an entity may need to reassess the useful life of an asset or test assets for impairment.

For example, if a company plans to reduce its greenhouse gas emissions by replacing its current manufacturing equipment with new technology and equipment that emits fewer greenhouse gases, it should evaluate whether such plans affect the recoverability of its existing manufacturing equipment and also reassess whether the current useful life of that existing equipment remains appropriate. Further, if a company has goodwill related to a reporting unit that includes the product lines produced by the existing equipment, it should assess whether its future manufacturing process will result in a different profit margin profile, which could affect the expected future cash flows of the reporting unit and ultimately alter the results of the entity's goodwill impairment test. Likewise, a different profit margin could have an impact on the recoverability of inventory and deferred tax asset balances.

Forecasted revenues or cash flows may be an assumption that a company uses in multiple impairment tests. When a single set of assumptions is used in multiple analyses, companies should verify that the same set of assumptions is being used in each analysis unless the applicable accounting rules permit otherwise. They should also verify that assumptions and estimates used outside of the financial statements (e.g., sustainability reports) are consistent with those used when preparing estimates in the financial statements.

## Disclosures

Companies will need to consider which disclosures are required for items recorded in the financial statements (e.g., asset impairments or liabilities) on the basis of existing accounting rules. Current rules also require companies to disclose information that helps financial statement users assess major risks and uncertainties — such as the use of estimates in the preparation of financial statements, including certain significant estimates, and current vulnerability due to specific concentrations. In addition, on the basis of current accounting rules, companies need to disclose certain items that are not recorded in the financial statements, including commitments.

Companies should evaluate their plans to reduce their carbon footprint to determine whether they have any major risks, uncertainties, or commitments that should be disclosed in their financial statements. In addition to the disclosure requirements set forth by accounting rules, companies should consider SEC reporting requirements as discussed above in the [SEC Activities Related to Environmental Matters](#) section.

## Trending Transactions

As companies take actions to reduce their carbon footprint and encourage others to do the same, new types of transactions are occurring frequently and they continue to evolve. Sustainability-linked debt and energy service agreements (ESAs) are but two such transactions that reflect a trend of incorporating environmental objectives into a company's ongoing business strategy and operations. And while environmental objectives are typically and rightfully the impetus of such transactions, the transactions may also require specific accounting considerations.

## **Sustainability-Linked Debt**

With regard to structure, the terms of sustainability-linked debt instruments and conventional debt instruments may be largely similar. However, each sustainability-linked debt instrument may have unique environmental linkage. For example, (1) debt instruments may be subject to early redemption if the borrower fails to meet a target sustainability metric (e.g., on the basis of S&P Global ESG Scores) on a specified date or (2) the contractual interest rate may be reduced if the borrower achieves predefined targets for reducing greenhouse gas emission.

The primary question related to sustainability-linked debt instruments with cash flows linked to environmental factors is whether the arrangement contains an embedded derivative that must be accounted for separately on the basis of the applicable accounting guidance. In many instances, this assessment depends on whether the variability linked to the environmental factors includes economic risks that are not clearly and closely related to the debt instrument itself.

If a company determines that a sustainability-linked debt instrument includes an embedded derivative, such a derivative must be accounted for separately at fair value both at the inception of the arrangement and for the life of the arrangement. The determination of the fair value of environmental-factor-related embedded derivatives involves complexity and often requires the involvement of valuation specialists.

## **Energy Service Agreements**

ESAs are often marketed as an “off-balance sheet financing solution” that will allow companies to capture the benefits of new efficient equipment without incurring the upfront capital expenditures associated with it. In addition to performing various services in connection with the ESA, the vendor will often replace all, or a portion, of a company's existing energy infrastructure (e.g., HVAC systems, boilers, lightbulbs) with new environmentally sustainable equipment and retain title to the equipment located at the company's location. Payments to the vendor are generally based on the company's actual cost savings — for example, as a percentage of the actual savings. Simply stated, in a typical ESA, a company will engage a vendor to help the company reduce its energy costs and, in return, the company will share a portion of its cost savings with the vendor.

From an accounting standpoint, the most significant considerations are whether an ESA includes an embedded lease for the underlying equipment and, if so, the amount of the related lease asset and liability to be recorded. We have observed that in many instances, ESAs will be deemed to include a lease because the company is able to control when the equipment is actually used and at what levels.

Because in many ESAs, the company only pays the vendor to the extent there are energy cost savings, the amount actually paid may appear entirely variable and therefore no lease liability or asset would be recorded. However, if all (or a portion) of the payments are, in effect, unavoidable, they may be viewed as being in-substance fixed payments and should be considered in the measurement of the lease asset and liability.

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