



# Memo

**To:** Chrissie Murray

**File ref:**

**From:** David Pearson

**Date:** 7 July 2017

**CC:** Kate Hodgkinson, Levi Rona, Craig Salmon, Scott Gulliver

**Re:** Accounting for Paris Agreement - Climate Change Emissions Targets

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## Purpose

1. The purpose of this memo is to:
  - seek your agreement on the proposed domestic financial accounting treatment of 2030 target emission reduction announcements made by the NZ Government.
  - note the financial impact of the proposed treatment on the Crown's financial statements.

## Issue One - target emission reduction announcements made by the Crown

### Background

2. The Paris Agreement (the Agreement) is the new global agreement on climate change. It was adopted by Parties to the United Nations Framework Convention on Climate Change (UNFCCC) on 12 December 2015. It commits all countries to take action on climate change. The Paris Agreement entered into force for New Zealand on 4 November 2016. New Zealand's first mitigation contribution under the Agreement (our Nationally Determined Contribution) will apply from 2021 until 2030.
3. The Agreement aims to:
  - a. keep the increase in global average temperature to well below 2° C above pre-industrial levels, while pursuing efforts to limit the temperature increase to 1.5° C (with a corollary aim to reach peaking of global greenhouse gas emissions as soon as possible and to reach net-zero emissions by the second half of the century).
  - b. enhance the ability of countries to adapt and reduce vulnerability to the adverse impacts of climate change
  - c. make sure that financial flows support the development of low-carbon and climate-resilient economies.

4. The Agreement provides a framework for the global response to climate change. Negotiations on more detailed rules (including those rules about the use of markets and the accounting for the land sector) are underway and are anticipated to conclude by 2018.
5. New Zealand's Nationally Determined Contribution (NDC) under the Agreement is to reduce greenhouse gas emissions by 30 per cent below 2005 levels by 2030.
6. The National Interest Analysis has useful background information on the legal nature of the provisions of the Paris Agreement. Use the following link to access this information:  
[https://www.parliament.nz/resource/en-NZ/00DBSCH\\_ITR\\_69746\\_1/78ae3af9672be07fa005a3898fcb3e48f2e58](https://www.parliament.nz/resource/en-NZ/00DBSCH_ITR_69746_1/78ae3af9672be07fa005a3898fcb3e48f2e58)
7. The possible economic costs of meeting the NDC are not currently recognised in the Crown's financial statements. The treatment reflects an accounting assumption that the NDC will not necessarily result in an economic sacrifice or outflow of economic resources for the Crown. The Crown may choose to buy units in the future to meet any shortfall arising from emissions in excess of its target to achieve New Zealand's NDC, but there is no legal requirement to meet it. Generally accepted accounting practice sets a high bar for recognising an obligation and if entity has discretion to avoid the obligation and not face a tangible economic sacrifice then no obligation can be recognised.

#### **Generally Accepted Accounting Practice**

8. Under generally accepted accounting practice, several tests must be met in order to recognise a possible obligation or unconditional commitment. These are presented below and have been derived primarily from the guidance note from The Treasury, *Guidance on Recognising Liabilities and Expenses (November 2013)* and PBE IPASB 19 (NZ IAS 37): *Provisions, Contingent Liabilities and Contingent Assets*. The tests are cumulative (i.e. all the tests must be met for an obligation to be recognised.)
  - a) Does the possible obligation arise pursuant to an exchange contract, legislation, deed, or government policy?
  - b) Is there a possible obligation involving another party to whom the obligation is owed?
  - c) Is there a possible obligation involving economic sacrifice?
  - d) Is the lack of economic sacrifice due to reimbursement of possible obligation?
  - e) Is the possible obligation ongoing and adjustable?
  - f) Can a reliable estimate be made of the obligation?
9. Further guidance and relevant commentary from PBE IPASB 19 (NZ IAS 37): *Provisions, Contingent Liabilities and Contingent Assets* are provided in Appendix 1 to this memo.

## Analysis

To determine whether an obligation should be recognised the specific tests are analysed below.

*(a) Does the possible obligation arise pursuant to an exchange contract, legislation, deed or government policy?*

10. There is no legal commitment to achieve the target; but we are required to implement policies and measures aimed at achieving it. A possible obligation is established by current policy and the announced target by the Government as opposed to an exchange contract, deed, or legislation. The policy does create an expectation that the Government will meet its target.

*(b) Is there a possible obligation involving another party to whom the obligation is owed?*

11. It is questionable as to who the other party is in this case. Is it other countries or the NZ public? NZ IAS 37 does indicate that an obligation can be made to the public at large. On the basis that the communication of the target has been made both domestically and internationally, this has created a valid expectation that the Government will discharge its responsibilities to achieve the target so this test is likely to be met. The announced target and commitment to the Paris Agreement will help enhance the reputation of NZ with its trading partners and have intangible benefits in trade negotiations.

*(c) Is there a possible obligation involving an economic sacrifice by the Crown?*

12. There is no legal commitment to achieve the target nor economic sacrifice from an accounting perspective. Although failure to achieve a target is likely to carry adverse reputational impacts, the Paris Agreement explicitly precludes a punitive compliance mechanism and therefore Parties will not be financially penalized for a failure to achieve targets. There could be negative impacts on trade negotiations if the Government does not meet its target but this does not equate to an enforcement provision or penalty for non-performance. No economic resources are given up if it doesn't meet the target. The Government may decide to buy units in the future if emissions are in excess of its target to meet its public commitment but there is currently no compulsion or requirement to do so. If the Government develops legislation to require it to meet its stated responsibility target this test could be met and it could be enforced by others, including the public.

The Paris Agreement creates an obligation to pursue domestic measures aimed at achieving the target. This means that the Government must implement policies. The accounting implications of these will be determined and applied as policies are implemented.

*(d) Is the lack of economic sacrifice due to reimbursement of possible obligation?*

13. Based on the announced target there is no economic sacrifice and therefore the notion of reimbursement is redundant. This test is not met. However, if the government imposes a fiscal cost on itself through legislation and seeks partial reimbursement through ETS participants this could be viewed as a reimbursement of the possible obligation. In such cases, the reimbursement and the economic sacrifice/obligation are likely to be accounted for separately or grossed up.

*(e) Is the possible obligation ongoing and adjustable?*

14. The Paris Agreement requires subsequent NDCs be progressively more ambitious. It also allows for adjustment of NDCs at any time (outside of the mandated communication points), although it currently ambiguous whether this means adjustment may be made both up and down.

*(f) Can a reliable estimate be made of the obligation?*

15. The details of how the target will be measured have been announced. The expectation is that the measurement approach will follow the 2006 IPCC rules or other guidance adopted by the Conference of the Parties. Therefore measurements and estimates can be made of future emissions and the possible obligation.

### **Conclusions and financial implications**

16. Based on the announced target and commitment as it stands, no obligation can be recognised on the Crown's financial statements because it doesn't result in an economic sacrifice or outflow of economic resources according to generally accepted accounting practice. Therefore the proposed accounting treatment has a nil financial impact for the Crown. However, if the Crown was to enshrine the target in legislation to meet its stated responsibility target this could change the accounting approach.

### **Possible disclosure**

17. To help track progress against its target and public commitment for CP2 we are currently considering recording and communicating progress (such as emissions incurred) separately in the annual report. We are yet to determine whether this will be included as part of the notes to the accounts and fall within the scope of the audit or be attached as additional information in a separate appendix. This disclosure will not impact on the Crown's operating balance or recognised liabilities in the financial statements.

18. In addition, we do not consider disclosure as a contingent liability is warranted because probability of any obligation and economic sacrifice is remote.

## **Appendix 1: Relevant guidance from PBE IPASB 19 (NZ IAS 37): *Provisions, Contingent Liabilities and Contingent Assets***

PBE IPSAS 19 (NZ IAS 37) deals with the treatment of provisions and contingent liabilities and contingent assets in the financial statements.

The standard distinguishes between provisions – which are recognised as liabilities because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and contingent liabilities – which are not recognised as liabilities because they are either:

1. possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or
2. present obligations that do not meet the recognition criteria in this Standard (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of the obligation cannot be made).

A provision must be recognised when:

- a. an entity has a present obligation (legal or constructive) as a result of a past event
- b. it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and
- c. a reliable estimate can be made of the obligation.

If these conditions are not met, a provision must not be recognised.

In cases where it is not clear whether there is a present obligation the standard stipulates that a past event is deemed to give rise to a present obligation if it is more likely than not that a present obligation exists at the balance date.

An event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

- (a) where the settlement of the obligation can be enforced by law; or
- (b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

Because financial statements deal with the financial position at the end of the reporting period and not its possible position in the future, the only liabilities recognised in an entity's statement of financial position are those that exist at the balance date. No provision is to be recognised for costs that need to be incurred to operate in the future.

Only those obligations arising from past events existing independently of an entity's future actions (i.e. the future conduct of its business) should be recognised as provisions. An entity may intend or need to carry out expenditure to operate in a particular way in the future because of constituent pressures or legal requirements, but if the entity may avoid the future expenditure by its future actions, for example by

changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large and in the case of contaminated sites the obligation is often expressed as being “to the environment”.

Because an obligation always involves a commitment to another party, it follows that a management or governing board decisions do not give rise to a constructive obligation at the balance date unless the decision has been communicated before the balance date to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.