Small investors could be big losers under federal climate change legislation

May 7 2010

(PhysOrg.com) -- Small investors could be big losers if a greenhouse gas reduction plan known as cap and trade becomes law and accounting standards for carbon credits have not been established, according to a new study released today by a University of California, Davis, professor.

In an analysis of pending federal legislation and accounting practices, UC Davis management professor Paul Griffin determined that U.S. companies would receive up to $36 billion in climate change allowances next year under provisions of a bill the U.S. House of Representatives passed last year.

But their balance sheets would show only $7.5 billion in allowances using an accounting procedure set by a federal energy agency. Companies also could choose from one of several other established accounting standards, each of which would produce very different results, according to Griffin.

"There will be confusion," said Griffin, an accounting expert at the UC Davis Graduate School of Management. "The average public investor will be at a disadvantage relative to a professional investor like Goldman Sachs."

When balance sheets do not give a clear picture of assets and liabilities, investors cannot accurately assess a firm's value, according to Griffin.

"It raises an issue of fairness," he said. "Everyone wants openness and transparency now, and this could move us away from that."

Under the bill now before the Senate, total greenhouse emissions would be capped, and companies would receive annual government emission allowances. Firms with low emissions could sell their unused allowances to firms that have exceeded their limits. The bill thus would create incentives for buyers and sellers of credits to cut emissions.

In 20 years, U.S. firms would receive approximately $700 billion in allowances under the bill.

"These are big numbers that should be reflected in balance sheets," Griffin said.

So far, the debate over cap and trade has been largely about the cost to consumers, the effect on the federal deficit and the impact on global climate change. There has been little discussion of what it would mean for the balance sheets of companies.

"The Securities and Exchange Commission hasn't given any guidance on the debits and the credits that would result from the bill," Griffin said.

In his study, Griffin compiled financial and emissions data of all firms in the Standard & Poor’s 500. Using this data and applying rules that might be used by accountants, he calculated how the financial statements of each of the large publicly traded companies would be affected under different accounting scenarios.

Applying standards used by the European Union, total assets from carbon credits on U.S. company balance sheets would be as high as $36 billion in the first year of the bill, according to Griffin's calculations. However, under U.S. Federal Energy Regulatory Commission standards, the total benefits received from the government would be shown as zero.

According to Griffin, companies could opt for a method that allows them to show zero benefit and zero liability from the government credits.

"A large swath of U.S. companies could account for an aggregate economic obligation of between $39 billion and $44 billion entirely off the books," Griffin said.

More information: Download the full study at: ssrn.com/abstract=1601122

Provided by UC Davis