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Accounting for Investments in Renewable Energy

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Over the last 10 years, the renewable energy industry has experienced rapid growth. This growth continues to be driven by knowledgeable entrepreneurs, public policy and changing societal priorities. Entrepreneurs have built businesses and renewable energy projects from the ground up. Public policy has enlisted renewable portfolio

standards, production/investment tax credits and grant programs to promote growth in the industry. Society has pushed individuals, businesses and governments to seek out new opportunities and alternatives to fossil fuels.

As the renewable energy industry continues to grow, so does the private sector's investment demand in renewable energy projects that will provide electricity to residents and businesses in the future. Many organizations are exploring renewable energy investment opportunities or already have invested in renewable energy projects. When evaluating and accounting for these investment opportunities, there are a number of accounting and regulatory matters for financial services organizations to consider.

Important Accounting Considerations

Accounting for Investments in Renewable Energy Projects

Generally, the developer (commonly referred to as the managing member) of renewable energy projects will organize limited liability companies (LLC) or limited liability partnerships (LLP) that develop, construct, own and operate the project (e.g., a biomass facility, solar array, wind farm). The managing member will then solicit funding for the projects (e.g., construction loans, term loans, capital). As the industry has grown, so has the pool of investors (e.g., insurance companies, financial institutions, private equity funds), and these investor are commonly referred to as tax equity members.

When investing capital into one of the aforementioned projects, your institution should carefully consider the guidance provided by the Financial Accounting Standards Board (FASB) regarding accounting for the investment as an equity method or cost method investment, or if it meets the requirements for consolidation. Determination is based on facts and circumstances, and management should carefully evaluate the terms of the project's operating agreement to make that determination. It is also important to note that the consolidation requirements will be changing upon adoption of the new FASB Accounting Standards Update 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*.

Accounting for Income Taxes

In addition to certain cash inflows from distributions, investors may receive tax benefits (e.g., investment tax credits, accelerated depreciation) from their investments in renewable energy projects. The state and/or federal investment tax credits (ITCs) generated from the project will flow to the investor (as defined in the project's operating agreement) and provide tax savings and deferred tax assets when not utilized in the current tax year. As applicable, state ITCs typically are received over a five-year period, while federal ITCs are received once the project is placed in service and claimed all in that one year. Tax accounting for the ITCs may utilize the flow-through method or the deferral method. The accelerated depreciation (MACRS) generated from the project will generally create a deferred tax liability as a result of the temporary difference in an investor's GAAP versus tax basis in that investment.

While the majority of renewable energy credits for community banks come through investments in limited liability entities, others may be achieved through acquiring eligible property and entering into sale-leaseback transactions that can have additional accounting implications for income taxes. There are currently two acceptable methods for accounting for the income tax credits:

- **Deferral method** — the income tax credit is reflected in income over the productive life of the acquired property. The deferral of the income tax credit is reported either as a reduction in the carrying amount of the related asset or in a separate deferral account and is reflected in income tax expense over the productive life of the acquired property. Typically the income tax credits are recognized in pretax income (i.e., reduction in depreciation expense or an increase in lease income).
- **Flow-through method** — the income tax credit is treated as a reduction of federal income taxes immediately in the year in which the credit is generated.

A temporary difference may arise when accounting for an income tax credit depending on which accounting method is selected. Whether applying the deferral or flow-through method, there are two alternative methods of accounting for any resulting temporary difference:

- **The gross-up method** – the deferred tax related to the temporary difference would be recorded as an adjustment to the carrying value of underlying asset.
- **The income statement method** – the deferred tax related to the temporary difference would be recorded in income tax provision expense.

The use of the deferral method or flow-through method, as well as the gross-up or income statement method, are both accounting policy elections and any change is subject to the requirements in ASC 250, *Accounting Changes and Error Corrections*.

Accounting for Commitments

Investors in renewable energy projects also should consider accounting for commitments to the investee. Generally, the investor would record the gross investment balance as another asset and the gross liability balance as another liability on the balance sheet. Management should consider if additional financial statement disclosures are necessary regarding the company's unfunded commitments to the investee(s).

Important Regulatory Considerations for Financial Institutions

While there are important accounting considerations for all investors in renewable energy projects, there are also important regulatory considerations for financial institutions. Those considerations may include:

- Determining if an investment in a renewable energy project (from here on referred to as the investment) is *in economic substance a loan* (from here on referred to as the loan), and:
 1. if the investment/loan should be underwritten in accordance with the institution's normal loan underwriting policies and procedures,
 2. if the loan is within the institution's legal lending limit,
 3. if the investment/loan is reported as a loan, investment or other asset, and
 4. if an investment in and a loan to a renewable energy project should be aggregated when evaluating total credit exposure (TCE) and the institution's legal lending limit.

We suggest that management make this evaluation during the due diligence process; inquire of your CPA, legal counsel and primary regulator, as considered necessary; and contemporaneously document management's considerations for these items.

- Determining the appropriate risk weighting of the investment/loan for regulatory capital purposes.

We suggest that management evaluate the current FFIEC RC-R instructions to determine the appropriate risk weighting.

- Who should own the investment – the bank or the holding company?

While it is not uncommon for a holding company to make the investment, we have commonly seen these investments made by the bank.

- The need to possibly engage legal counsel and/or a CPA, or to inquire of your legal counsel and/or auditors, to assist in evaluating the aforementioned regulatory considerations.

When inquiring of your external auditors, management should be aware that certain limitations, as prescribed by auditing standards, or client service relationships, with the investor/investee, may limit the auditors' ability to provide guidance in order to avoid potential impairments of independence.

- The need to inquire of or inform your regulator as to a possible or recent investment in a renewable energy project.

Management may also consider reviewing relevant FDIC Financial Institution Letters, Federal Reserve Supervisory and Regulation Letters and OCC Interpretive Letters (e.g., Interpretive Letter #1048 – January 2006 – 12 USC 29).

While the accounting for investments in renewable energy projects is not overly complex, management needs to carefully consider the potential accounting, reporting/disclosure and regulatory implications of such investments, especially when those investments are material to the institution's financial statements. Management also should document assessment of the pertinent accounting and regulatory issues related to these items. It is equally as important to assess the need to establish and document internal controls that support the institution's objectives, while ensuring proper accounting treatment for and reporting/disclosure of such investments. As a firm with experience providing advisory, assurance attestation services to financial institutions, companies within the renewable energy industry and other types of investors, DHG is ready to serve you.

About DHG Financial Services

DHG Financial Services, a national practice of Dixon Hughes Goodman, focuses on publicly traded and privately-held financial services companies across the U.S. Our 30 financial services partners and more than 300 dedicated professionals provide you with in-depth, specialized industry knowledge and a wide range of assurance, tax and advisory services to address issues facing your industry in today's challenging environment. For more information, visit dhgllp.com/financial-services.

About the Authors

Matt Miller is a senior associate in the DHG Financial Services practice. Matt has more than two years of experience with public and private financial institutions and more than four years of experience with companies in the renewable energy industry. He works primarily in the area of financial statement audits and reviews, internal control evaluation and Sarbanes-Oxley (SOX) compliance.

Adam Thomas, Partner, DHG Financial Services, has 14 years' experience serving financial institutions. Adam has significant experience working with public companies, including navigating business combinations, liaising with SEC counsel, reviewing SEC filings and auditing internal controls (for both FDICIA and Sarbanes-Oxley). Adam has led internal and external training sessions, with subject matter ranging from the allowance for loan losses to acquired loan accounting. Adam also brings experience with dealing with share-based compensation, fair value measurements, and income tax provision accounting.

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