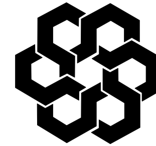

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**12 December 2007, London**
Project:	**Accounting for Emissions Trading Schemes**
Subject:	**Reproduction of September 2005 Agenda Proposal (Agenda Paper 5B(i))**

Introduction

1 The purpose of this paper is for the Board to consider whether to add a project to its technical agenda to provide guidance on how to account for emission trading schemes.

2 After the staff recommendation the paper is structured as follows:

- Background—a brief reminder of the IFRIC's work on emission trading schemes and the reasons for the withdrawal of its Interpretation IFRIC 3 *Emission Rights* [¶7-¶19].
- Project issues—a discussion about the main issues that the staff thinks will need to be considered in this project. This section is divided into two sub-sections:
    - a consideration of the *scope* of the proposed project [¶20-¶30], and

- a consideration of the main *technical issues* that would arise in the project [¶31-¶67].

- IASB agenda criteria—an analysis of the proposed project relative to the agenda criteria set out in the draft due process handbook [¶68-¶94].

- Project plan [¶95-¶101].

3 The staff has also provided background information in appendices as follows (appendices omitted from observer note):

- Background information covering emissions trading schemes and the Kyoto Protocol [Appendix A].

- A summary of IFRIC 3 [Appendix B].

- Other national accounting guidance on emission trading schemes [Appendix C].

Recommendation

4 The staff recommends that the Board adds a project to its technical agenda to assist entities in accounting for emission trading schemes. The staff recommends that the scope of this project should be limited to addressing the following key issues.

1 Are the tradeable permits in emission trading schemes (allowances and credits) assets?

If so,

2 How should an entity account for any allowances that it receives from government for less than fair value?

3 How should allowances and credits be accounted for?

4 How should changes in assets and liabilities (arising from emission trading schemes) be reported in profit or loss?

5 Given this scope, the staff does not envisage that the outcome of the project would result in a new IFRS. Rather, we believe that these issues can be addressed by:

(a) a revision of either IAS 38 *Intangible Assets* or IAS 39 *Financial Instruments: Recognition and Measurement* to accommodate the accounting for tradeable permits, and

(b) a revision of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* so that the accounting for allowances (and similar assets) issued by governments free of charge is addressed.

6 The Board already has an active project on its agenda to revise IAS 20. Because of the importance of issue 2 above to the IAS 20 project, the staff recommends that the Emissions Trading Project and the IAS 20 project proceed concurrently.

Background

History of IFRIC's work

7 Schemes designed to achieve a reduction of greenhouse gases through the use of tradeable emission permits—emission trading schemes—are a relatively recent phenomena, although the concept of using a tradeable permit as a means of efficiently achieving a social objective has been familiar to economists for some time. Such schemes are an integral part of the Kyoto Protocol, the 1997 international agreement under which most developed countries agreed to legally binding targets that will reduce emissions of the six main greenhouse gases by at least 5% below 1990 levels over the period 2008-2012.

8 As a result of its commitment under the Kyoto Protocol, the European Union started its European-wide Emission Trading Scheme (the EU ETS) in January 2005. This is the largest company-level, multi-sector cap and trade emissions trading scheme in the world.[1]

9 There have been important schemes prior to the EU ETS, eg the program for the reduction of SO_2 emissions from electric utilities that was initiated in the US in 1995. However, it was the proposals for the EU ETS that provoked a lively debate in the accounting profession about the appropriate accounting treatment.

---

[1] Appendix A contains details of the EU ETS scheme.

10 As no informal consensus had been reached in this debate (in particular about the accounting treatment for allowances issued for less than fair value by government), and because the EU ETS would affect many IFRS preparers in Europe, the IFRIC decided in 2002 that it should develop an interpretation to explain how entities should apply IFRSs to cap and trade schemes like the EU ETS.

11 The IFRIC developed its consensus over two meetings in 2002 and eventually issued draft interpretation D1 *Emission Rights* in May 2003.

12 Many respondents to D1 welcomed that the IFRIC had tackled this topic—they thought that guidance in this area was important, although some observed that because emission trading schemes were in their infancy the guidance was premature. However, few respondents welcomed the specifics of the IFRIC's interpretation.[2] In particular, many respondents cited a scenario in which an entity receives allowances at the start of the year equal to anticipated emissions for the year and in which the entity does not trade its allowances, because the allowances will be held to settle the forecast year-end emission obligation. These respondents contended that the accounting in this scenario should have no effect on profit or loss because the entity was emitting within its allowed limit. Thus many expressed the view that a net loss (net gain) should be reported in profit or loss only if the entity produced more (fewer) emissions than the allowances it was given free of charge (or if the entity traded its allowances).

13 During its redeliberations, the IFRIC considered but rejected alternative interpretations offered by respondents. It concluded that D1 was the only interpretation of IFRSs (even though it had precluded the use of one of the options in IAS 20). Nonetheless, the IFRIC was troubled by the effects in profit or loss of the mixed measurements of the standards that it was interpreting (ie allowances under IAS 38 at *cost*, emission obligations at a *current value* under IAS 37) and mixed reporting (ie changes in the value of allowances measured at fair value in *equity*, changes in the value of emission obligation in *profit or loss*).

14 Accordingly, in December 2003, the IFRIC sought the Board's permission to develop a possible amendment of IAS 38. The objective of the amendment was to create a

[2] Details of IFRIC 3 (which was largely the same as D1) are in Appendix B.

new subset of intangible assets in IAS 38, including emission allowances, which could be measured at fair value through profit or loss. The IFRIC's view was that this would alleviate some (but not all) of the effects in profit or loss from the mixed measurement and reporting requirements of IASs 38 and 37. This is because the asset (allowance) and liability (emission obligation) would be measured on a consistent basis with all changes in value reported in the same place, ie profit or loss.

15 The Board agreed that the IFRIC could pursue considering such an amendment of IAS 38. However, the Board also noted that in 2002 it had decided to amend IAS 20 (which the IFRIC had concluded determined the accounting treatment of allowances issued for less than fair value by government). The Board therefore proposed that the IFRIC's amendment to IAS 38 and its own work on IAS 20 should be linked and issued as a package later in 2004, together with a new draft Interpretation based on the proposed amended Standards.

16 Due to agenda and staff constraints, little progress was made on IAS 20 in 2004. Meanwhile the IFRIC was coming under pressure from constituents about the lack of guidance on accounting for the EU ETS. Therefore, in September 2004, the IFRIC decided to issue its Interpretation (IFRIC 3) largely as exposed in D1.[3] It also emphasised to its constituents that it was committed to developing an amendment to IAS 38 for the Board's consideration as soon as possible.

Withdrawal of IFRIC 3

17 During 2005, the IFRIC developed its proposed amendment of IAS 38. The EFRAG staff also developed a model for accounting for the EU ETS. Not only did they propose measuring the allowances at fair value like the IFRIC, they also proposed that gains and losses on allowances held to meet highly probable emission obligations should be deferred in equity and recognised when those emissions occurred (ie a cash flow hedging model). The IFRIC's work and the EFRAG proposal were considered by the Board at its June meeting.

18 In June, the Board also considered a request from the European Commission to defer the effective date of IFRIC 3 (although it was already effective from 1 March 2005).

[3] IFRIC 3 was eventually issued in December 2004.

The EC observed that markets for EU allowances, which are necessary for the proper functioning of the EU ETS, although developing rapidly, were thin. As a result, the Board observed that there was not as urgent a need for an Interpretation as originally concluded by the IFRIC in 2004.

19 Accordingly, in the light of the reduced urgency for an Interpretation and the requests from the IFRIC to amend Standards, the Board decided to withdraw IFRIC 3 so that, free of the IFRIC's constraint of *interpreting* existing Standards, it could address the underlying accounting in a more comprehensive way than originally envisaged by the IFRIC.

Project issues

1 Scope of the proposed project

20 IFRIC 3 dealt with the key issues that the IFRIC concluded arose for a *participant* in a *cap and trade* emissions trading scheme that is *operational*,[4] namely:

1 are allowances an asset,

if so,

2 what is the nature of the asset, and

3 what is the corresponding entry on recognising allowances issued by government for free (and subsequent accounting),

4 when does a liability arise for obligations under a cap and trade scheme.[5]

21 The Board should note that a few respondents to the draft Interpretation argued that the IFRIC should have tackled a broader scope project, in effect objecting to IFRIC primarily addressing the issue for one constituency group, Europe. For example, the IFRIC was asked to consider accounting issues that arise in baseline and credit schemes[6] and renewable energy certificates schemes[7].

---

[4] ie a scheme like the EU ETS. A generic cap and trade scheme is described in Appendix A.
[5] Note, however, that IFRIC 3 did specifically state that its principles might be relevant to other schemes that are also designed to encourage reduced emission levels.
[6] see Appendix A for a description.
[7] see Appendix A for a description.

22 The IFRIC was also asked to address additional issues that arise in cap and trade schemes. These included:

- accounting treatment of penalties, particularly non-cash penalties (eg a requirement to reduce emissions in a subsequent year),
- measurement of allowances and emission obligations when there is no active market for allowances,
- recognition and measurement of impairment losses arising from the imposition of emission caps and baselines,
- accounting by brokers or other position-taking institutions, ie entities who are not participants in the trading scheme and to whom allowances are not issued,
- treatment for derecognition of allowances if not measured at fair value (ie, if allowances are measured at cost and a partial sale occurs, how should the cost of the allowances derecognised be determined),
- recognition of any incentives and subsidies that entities receive from governments as a result of participating in the scheme,
- recognition guidance for allowances when they are allocated for, say, a five year period but issued in five annual instalments (as in EU ETS),
- accounting implications of 'banking' rules (ie the ability to carry forward 'unused' allowances into a subsequent period),
- disclosure requirements.

23 In the light of these comments on D1, the Board needs to consider whether to undertake a standalone project covering emission reduction schemes in general (or indeed other schemes that make use of tradeable permit for other environmental or resource problems[8]). Such a project would consider the principal accounting issues

---

[8] An OECD reports in 1999 and 2002, reported that the concept of tradable permits was found in air-pollution control, fisheries, water and land-use control, with more recent developments including renewable energy certificates, tradable energy efficiency improvement certificates, waste management as well as many developments in the field of greenhouse gases.

that arise in the various types of emission reduction schemes developed to date. The output of this project would probably be a new IFRS called Emission Schemes or Emission Trading Schemes (if the scope were limited to schemes that make use of a tradeable permit).

24 The staff notes that such a project would require the staff to undertake significantly more research to identify the appropriate scope.

25 However, the staff does not recommend such a project. We think that because fully functioning market-based schemes are still in their infancy (eg EU ETS[9]), the IFRIC's conclusion that there are a limited number of key issues that need to be clarified at the present time remains valid. We also think that because the most difficult accounting issues relate to the treatment of the tradeable permit, most of the key issues that have to be addressed in dealing with the EU ETS (ie a cap and trade scheme) are also relevant in other schemes that use tradeable permits or similar instruments (eg baseline and credit, renewable energy certificates).

26 With respect to the other issues that the IFRIC was asked to consider, we think that many of these are not specific to emission trading schemes. If they do eventually need addressing, because they become pervasive practice issues, they might best be dealt with through interpretative or educational guidance once the key issues have been resolved.[10]

27 Therefore, the staff recommends that the scope of this project, like IFRIC 3, be limited to addressing the key issues identified and discussed in paragraphs 31-67.

28 Nonetheless, the staff recommends that in this project the Board does not limit its discussions only to the EU ETS. We think that considering the issues surrounding tradeable permits in the context of other schemes might provide new insights to the Board's discussions. For example, those who argue that entities should account only for their shortfall or excess allowances (ie emissions above or below the allowances

---

[9] It is worth noting that the EC is currently reviewing the application of the EU ETS and will report by June 2006. The review will cover inter alia the scope of the scheme (ie sectors and gases), role of international climate change obligations, harmonisation of allocation methodologies, use of credits from Kyoto projects. Because Phase II starts in 2008, significant amendments from this review would apply from Phase III onwards.

[10] [footnote omitted from observer note]

given) in a cap and trade scheme might find it useful to consider the difference between a cap and trade scheme and a baseline and credit scheme.

29 Considering other schemes is also important because of the way the various initiatives under the Kyoto Protocol interact (for example, an entity in the EU ETS may well be able to earn a credit from an emission reduction project in a developing nation and then use that credit equivalently to an allowance to satisfy its domestic emission obligation).[11]

30 The staff thinks that the nature of the issues to be considered in the project might mean that the output of the project could be limited to co-ordinated amendments to existing IFRSs, so that they better deal with emission trading schemes, rather than a new IFRS. Put another way, we think that our objective should be to remove the impediments in our current Standards that caused the IFRIC problems when it developed IFRIC 3.

2 Accounting issues to be considered in the project

31 The main issued that the IFRIC addressed are listed in paragraph 20. Of these, the staff thinks that the last—when does an obligation arise in an emission trading scheme—does not need to be reconsidered by the Board. Particularly in view of the Board's proposed amendments to IAS 37, the staff thinks that it is clear that in a cap and trade scheme a liability to deliver allowances arises only as emissions occur and that the liability is in the scope of IAS 37. This is consistent with similar types of obligations such as environmental clean-up obligations.

32 Therefore, based on the IFRIC's work and the Board's discussions to date, the staff thinks that there are three fundamental issues to be addressed:

1 Are allowances/credits assets?

If so:

[11] This process is governed by the EU Linking Directive which provides for the possibility of allowing operators to use credits from the Kyoto Protocol project-based mechanisms (Clean Development Mechanism and Joint Implementation) to comply with their obligations under the EU ETS. See Appendix A.

2 what is the corresponding entry for an entity that receives allowances[12] from government free of charge?

3 How should allowances/credits be accounted for?

These three issues then raise a fourth issue:

4 How should the effects of changes in the assets and liabilities arising from an emission trading scheme be reported in profit or loss?

Issue 1: Are allowances/credits assets?

Purchased allowances

33 The question is best considered first by considering an entity that buys an allowance or credit.

34 In a properly functioning emission trading scheme, entities will buy allowances from other participants in the scheme or from traders in allowances. This after all is the nature of the scheme and why it reduces the overall costs to entities of achieving the environmental goal of reduced emissions than in the case of centralised environmental regulation such as a carbon tax.

35 Entities also buy allowances from government. This has not been a key feature of the EU ETS to date, because most allowances in Phase I are being issued for free. But in Phase II (ie from 2008), governments will be able to auction up to 10 per cent of allowances. (Indeed, if the price of carbon were to be fully taken into account by entities, *all* allowances would initially be auctioned by government rather than issued for free. Whether and how quickly the EU would move to this position is very uncertain. But, as discussed below, the point is worth bearing in mind when considering whether allowances issued free of charge by government should be treated differently from purchased allowances.)

36 The IFRIC concluded that an allowance that is purchased is an asset that should be recognised. We think few would dispute this conclusion.

---

[12] Credits, unlike allowances, are not received free of charge—they are awarded in exchange for achieving reductions in emissions (for example under the Clean Development Mechanism—see Appendix A).

Allowances issued for less than fair value by government

37 Despite the theoretical ideal of auctioning allowances, at least 90 per cent of allowances in Phase II of the EU ETS will be issued for free by governments. Therefore, if it is concluded that a purchased allowance is an asset that should be recognised, the next key issue to address is whether it makes any difference to that conclusion if the allowance is allocated by government for less than fair value.

38 The IFRIC concluded that allocated allowances were also assets and that they should also be recognised. The IFRIC noted that allowances are fungible—there is no difference for an entity between an allowance allocated by government and one that is purchased. Both can be sold by the entity or held to settle future emission obligations. The IFRIC could find no reason for treating them differently. In effect, the IFRIC decided that *how* an entity gets its allowance is irrelevant to how those allowances should be accounted for.

39 Some, however, argue that allowances issued by government for free should be treated differently from purchased allowances and do not warrant recognition as an asset. This view mainly arises as a result of considering the entity's position before and after the introduction of the emission scheme. That is to say, before the introduction of the scheme the entity has a right to produce unlimited emissions at no cost, whereas afterwards the entity has been given some permits that grant it a right to produce a specified level of emissions (likely to be below its existing level of emissions) and emissions above that level will result in an additional cost. The permits are tradeable, but the entity is not 'better off'. In fact it is worse off because its right to emit has been capped.

Issue 2: What is the corresponding entry on recognising an allowance issued by government?

40 If it is concluded that an allowance issued by government is also an asset that should be recognised, we come to the issue that the staff thinks, based on past experience, is likely to be the most difficult, namely: is the corresponding credit income or a liability.

41 The reason why this issue is difficult is because to date neither the staff nor the IFRIC has identified that an entity (in the EU ETS) has incurred a present obligation as a

result of receiving allowances from government for less than fair value. The entity has no *obligation* to do anything. But some find the consequence of this troubling because, under the *Framework*, it would mean that when the allowances are received from government, income would be recognised in profit or loss. However, the government gave the allowances to the entity in contemplation of the entity's expected future emissions. And as these expected future emissions occur, the entity will incur an expense in profit or loss that effectively reverses the gain initially recognised.[13]

42 This issue cross-cuts with the Board's project to amend IAS 20 because an issue of allowances by government satisfies the definition of a government grant in IAS 20, namely 'assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity…'. To date, the Board has not proposed any amendments to the definition of a government grant that would affect this conclusion.

43 In its project to amend IAS 20 the Board has decided to eliminate the requirement to recognise grants as income over the periods necessary to match them with the costs that they are intended to compensate. Instead, the Board has decided that grants should be characterised as either grants without conditions or grants with conditions. The former would be recognised as an asset (or reduction in liability) and the corresponding accounting entry would be income. The latter would similarly be recognised as an asset, but the corresponding accounting entry would be a liability, representing that the entity has a liability to return the grant if a specified condition is not met. Income from a grant with conditions would be recognised only when the condition is satisfied.

44 The Board has also decided to eliminate the option in IAS 20 that allows entities to recognise the transfer of a non-monetary asset from government at a nominal amount (ie at nil). In other words, a transferred resource will now be recognised (unless it cannot be measured reliably).

---

[13] In 2003, the EITF added to its agenda, but subsequently removed, the topic of accounting for a cap and trade scheme. In recording the decision to remove the topic from the agenda, EITF 03-14 reports that 'Other Task Force members raised concerns about the prospect of an accounting model that might permit immediate recognition of income upon receipt of the emissions allowances with the costs of complying with the related regulations being recognized subsequently as an expense.'

45 Regardless of the Board's decisions about the emissions trading project, the staff has some outstanding issues about the meaning of 'condition' in the context of government grants that need to be discussed. However, to date, the Board has been defining *condition* in terms of the government's right to the return of the granted resources if a specified future event either occurs or fails to occur.

46 Once the Board has considered the notion of a conditional government grant generally, it will need to consider whether a grant of allowances (ie tradeable permits) is a conditional or unconditional grant.

47 Some conclude that the grant of allowances is unconditional because the government has no right of return over the allowances. Thus they view the grant of allowances as a financial incentive that mitigates the cost of the scheme (ie the cost of producing emissions). They note that the entity has no obligation to do anything in return for receiving the allowances—ultimately it can close a plant and sell all of its allowances. Whilst this scenario might appear extreme, the staff notes that allowances are given to each emitting source. Hence, in the UK for example, it was expected that some power entities would close coal-fired power stations and shift production to gas-power stations.

48 In addition, as noted above, over time, it is possible that the incentive of free allowances will be reduced as government make greater use of auctions for distributing allowances. Some find this a persuasive argument for asserting that the entity has no obligation as a result of receiving the allowances for free. That is to say, they contend that if the entity paid for its allowances, no one would argue that the entity had a liability. Since the entity's obligations under the scheme are the same regardless of whether it buys allowances or receives them for free, it follows that the entity cannot have a liability as result of receiving its allowances for free.

49 Others, however, argue that there is an element of conditionality. For example, some argue that the requirement to deliver allowances equal to actual emissions can be regarded as a condition of the grant. This means that the grant can be regarded as conditional on the entity reducing its emissions below the cap (ie refraining from emitting), since the entity ultimately can retain the allowances (and benefit from the grant) only to the extent it does.

50 The staff thinks that in considering the accounting for allowances issued free of charge, it will be necessary and useful to consider other examples of assets awarded by government at nil cost, for example landing slots at airports.

51 If the Board concludes that the issue of allowances is an unconditional government grant, then under the tentative IAS 20 decision, the corresponding entry would be income. The consequence of this is discussed below in paragraphs 60-67.

52 If the Board concludes that the issue of allowances is a conditional government grant, then under the tentative IAS 20 decisions the corresponding accounting entry would be a liability. This liability would be extinguished when the condition is satisfied. The Board would therefore need to consider how this conclusion interacts with the conclusion under IAS 37 that a liability arises only when the entity produces emissions. In other words, would the condition be satisfied as the entity produces emissions?

Issue 3: How should allowances and credits be accounted for?

53 If allowances (whether purchased or issued for less than fair value) and credits are assets, the Board needs to decide how they should be accounted for.

54 The IFRIC decided that an allowance meets the definition of an intangible asset but not that of a financial asset. However, it acknowledged that because allowances are intended to be readily tradeable they share features that are more typically found in financial assets than the types of assets mentioned in IAS 38. Indeed, IAS 38 specifically states that it is 'uncommon' for there to be an active market for an intangible asset.

55 The IFRIC also found that IAS 38 did not provide a particularly satisfactory model for accounting for emission allowances. This is because the IFRIC concluded that fair value measurement is the most relevant measurement attribute for an allowance, but the measurement basis in IAS 38 is either cost less depreciation and impairment or fair value less depreciation and impairment. Furthermore, changes in fair value above cost are recognised in equity rather than profit or loss, which is inconsistent with the way that changes in the emission liability are recognised.

56 Working within the confines of existing Standards, there are three possible solutions to this problem:

1. The revaluation model in IAS 38 could be amended so that changes in the value of *any* qualifying intangible asset are recognised in profit or loss rather than equity.

2. IAS 38 could be amended to introduce a third measurement model (fair value through profit or loss).

3. IAS 39 could be amended to allow allowances to be treated as if they are a financial instrument.

57 The IFRIC has done some work on the second solution that may be useful to the Board. The IAS 39 solution appears attractive, but the Board would need to find a rationale for treating the tradeable permit in an emission scheme differently from other tradeable permits such as quotas that IAS 38 explains are examples of intangible assets. One such rationale, the notion that the permit is more like a currency rather than a license to do something, has already been explored and developed by the IFRIC.

58 The last two options would also require the Board to consider whether the amendments would apply only to emission allowances and credits (that is, if they can be satisfactorily defined) or whether they should apply to a defined subset of assets that would include allowances or credits (again, the challenge being to define that subset).

59 The Board may also need to consider whether there is a need for different classes of tradeable permits, similar to the different categories of financial assets in IAS 39. For example, the Board may conclude there is a need to distinguish allowances or credits that the entity intends to trade from those that are intended to be held for the purposes of meeting future emission obligations.

Issue 4: How should the effects of changes in the assets and liabilities arising from an emission trading scheme be reported in profit or loss?

60 Critics of IFRIC 3 were primarily concerned about the way that the changes in the assets and liabilities (and deferred credits) arising from an emission trading scheme were reported and the effect that this had on reported profit or loss. The most common complaint was that IFRIC 3 resulted in 'artificial volatility' of reported profit or loss.

61 To some extent, the complaint was justified. This is because accounting for allowances in IAS 38 does cause either a measurement mismatch (asset at cost, liability in accordance with IAS 37 at a current value) or a reporting mismatch (changes in the fair value of the asset in equity, changes in the value of the liability in profit or loss). The effect of these mismatches in profit or loss made it difficult to explain and interpret the effect of the EU ETS on the entity.

62 IFRIC proposed dealing with these mismatches by introducing into IAS 38 a fair value through profit or loss model for the allowance. However, for some of the IFRIC, this highlighted another source of volatility in profit or loss. This stems from the fact that allowances are issued at the start of the compliance year whilst emissions are incurred over the year. Thus if the assets and liabilities are measured at fair value, the change in the fair value of the asset in the earlier part of the year will be greater than the change in the value of the liability. Only when allowances in hand equal emissions incurred would the changes in the value of the asset and liability naturally offset.

63 Some constituents, including the EFRAG, suggested that the effects of these timing differences could be dealt with by using a cash flow hedge accounting model. In other words, the gains and losses on the asset would be deferred in equity and recycled to profit or loss when the offsetting gains and losses on the liability are recognised in reported or profit or loss. The IFRIC saw merit in exploring this approach. However, the staff notes that although the effects of the timing differences might cause volatility, it is not artificial. It is simply a function of the change in the market price of the allowances on the entity's portfolio of allowances and its

obligation from emissions to date. Arguably reporting this volatility is merely an example of 'telling it as it is'.

64 That said, all of these constituents were seeking to reduce the effects on profit or loss of this timing difference in the context of the current version of IAS 20. As noted above, if the issue of allowances by government is viewed as an *unconditional* government grant of a recognisable asset, there is another timing difference. This is because income would arise at the point of initial recognition of the allowances (ie at the start of the compliance period) rather than, under the present version of IAS 20, being deferred and recognised *over* the compliance period.

65 When D1 was exposed, only one commentator peeked ahead to consider the possible effects of the Board's project to amend IAS 20 on IFRIC's consensus. That commentator considered the effect to be very troubling. On the basis of individual discussions with some European preparers, the staff thinks that this view is likely to be widespread. This is because these entities argue that, although they may have no obligation to produce emissions, if they are to remain a going concern they will produce emissions at least equal to a large proportion of the number of allowances they were given by government. Therefore, they are almost certain that they will incur an expense over the emitting year that will reverse all of (or the majority of) any gain arising from immediate recognition of the allowances. The interim income statement that includes the date on which the allowances are recognised is therefore thought to be misleading to users, because it suggests that the entity has made a profit when that profit will be extinguished by higher operating costs in the subsequent period. And the nearer the date of recognising the allowance to the interim period end, the more pronounced the effect of immediate recognition of allowances in profit or loss. (Note the effect of the immediate recognition of the allowances in income would be less noticeable in the annual income statement, because each yearly income statement includes income from the receipt of the allowances and an expense from 12 months of emissions.)

66 Accordingly, the staff thinks that during the project users should be consulted to discuss their information needs. We need to find out if users share the same concern as preparers about reporting the changes in recognisable assets and liabilities as they arise in profit or loss.

67 That said, if the IFRIC's analysis of the assets and liabilities in IFRIC 3 was correct, the staff cannot see any way of addressing these timing issues, other than by breaching the *Framework*. For example, one way would be to recognise both the credit on initial recognition of an allowance held for the purposes of settling a highly probable emission obligation and any subsequent changes in its value in equity until the obligation is incurred.

IASB agenda criteria

68 The draft due process handbook sets out five criteria to be considered in deciding whether to add a potential item to the agenda:

1 The relevance to users of the information involved and the reliability of information that could be provided

2 Existing guidance available

3 Possibility of increasing convergence

4 Quality of the standards to be developed

5 Resource constraints

1 The relevance to users of the information involved and the reliability of information that could be provided

69 The objective of a project should be to address a demand for better quality information that is of value to all users of financial statements. In considering this, there are three main factors to consider:

International relevance and pervasiveness

70 According to *The Economist*[14] carbon trading used to be regarded as 'a fantasy marriage of environmentalism and economics' but is now seen as 'the least costly, least distorting and most effective way to curb carbon emissions'. It is also a central part of the Kyoto Protocol, an important international agreement. Therefore, although this project would, at the present time, be addressing primarily the needs of certain constituents in Europe, because Europe is home to the largest operational emissions

---

[14] *Global warming – better than Kyoto*, 25 June 2005

trading scheme, it is expected that similar schemes will become more widespread. For example, Canada and Japan are currently considering employing similar schemes as means of reducing emissions. In addition, it is possible that more entities will be caught by the European scheme after 2008.

Urgency

71 One of the main reasons for IFRIC initially tackling carbon trading schemes and then issuing its Interpretation, despite there being no widespread acceptance of its proposals, was the start of the EU ETS in January 2005. The IFRIC had been asked for authoritative guidance to ensure consistent accounting for this scheme and believed that it was important that participants in this scheme should have guidance as soon as possible.

72 In retrospect, it has become apparent that Phase I of the EU ETS (2005-7) should perhaps be viewed as a trial phase. Certainly, it is clear that although the scheme officially started in January, there has been considerable uncertainty this year, for example about the number of allowances to be issued, and delays in implementing the mechanisms to support trading between participants in the scheme. It has also been noted by some commentators that with participants able to use their 2006 allowances to settle any shortfall in their 2005 obligations (ie excess of emissions over 2005 allocation) and similarly 2007 for 2006, some participants may not be in the marketplace until 2007, thereby diminishing the effectiveness of the scheme.

73 Arguably, therefore, with the scheme in a trial phase there is no immediate need for accounting guidance to replace IFRIC 3. However, by the start of Phase II of the ETS in 2008, governments, entities and the markets will have learned much. There will be a demand by users of financial statements for consistent and transparent accounting treatment.

74 There is also likely to be an expectation amongst constituents that the IASB should fill, on a timely basis, the accounting gap that it created by withdrawing IFRIC 3 and that it should resolve the constraints in IFRSs that caused difficulties in IFRIC 3. In

other words, because the Board has withdrawn IFRIC 3, some European entities are now expecting and encouraging the Board to develop a better solution.[15]

Consequences of not taking on this project

75 In the absence of guidance to the contrary, the staff expects most entities to adopt a net accounting model: ie, allowances issued by government will not be recognised and a liability will be recognised when emissions exceed allowances in hand.[16]

76 Without wishing to prejudge the Board's consideration of the technical issues, the staff believes that this accounting does not provide users of financial information with transparent information. In particular it masks the functioning of the market mechanism that is at the heart of the EU ETS and similar schemes and which is why emissions trading is believed to be the least costly and most efficient way of forcing entities to reduce emissions. Hence, the staff believes that net accounting does not properly reflect the economics of the scheme that it purports to represent. It does not properly depict to users how the entity is responding to changes in the market value of allowances.

77 Entities may also follow some of the other interpretations that were suggested by constituents during the exposure of D1. The range of interpretations offered suggests that there could be considerable diversity of accounting in the absence of authoritative guidance.[17] Indeed it was the lack of any informal market consensus that was a stated reason for the IFRIC tackling the topic. If different entities account for similar schemes differently, users do not have consistent and comparable financial information.

2 Existing guidance available

Other national accounting guidance

78 Emissions trading is a relatively recent phenomena, so not surprisingly there is very little guidance. In Appendix C, we have provided details of the guidance of which we

[15] [footnote omitted from observer note]
[16] [footnote omitted from observer note]
[17] [footnote omitted from observer note]

are aware. We would have reservations about applying this guidance under IFRSs. Therefore, we think that there is a gap in international accounting literature.

Applying existing IFRSs to carbon trading schemes

79 In the staff's view, the IFRIC's work has demonstrated that our existing Standards do not provide a satisfactory basis for accounting for emission trading schemes. This is primarily because allowances, if they are assets, satisfy the intangible asset definition even though they have characteristics that are more often associated with financial assets than the types of assets dealt with in IAS 38. In addition, accounting for the assets as intangible assets causes measurement or reporting mismatches that make it difficult for users to understand the effects of the emission rights scheme on the financial statements. In some cases, counterintuitive results would be reported, for example a loss in profit or loss when the market price of an allowance has increased.

80 We therefore think that there is a need to remove the impediments in our existing Standards that caused the difficulties for the IFRIC in developing its Interpretation.

3 Possibility of increasing convergence

81 Because there is little accounting guidance in this area, this project offers the opportunity for the Board to provide leadership in the appropriate accounting for emission trading schemes. A high-quality solution from the Board would mean that other standard-setters with conceptual frameworks similar to ours could look to IFRS as required when developing guidance in their own countries.

4 Quality of the standards to be developed

Availability of alternative solutions

82 Because the IFRIC has undertaken work on this project since 2002, there has already been a lively debate about the appropriate accounting for emission right schemes and various models have been suggested. As reported to the Board in June 2005, the IFRIC has also spent two meetings discussing possible amendments to IFRSs that, in its view, would have improved IFRIC 3 by enhancing the faithful representation of the scheme and the understandability of the financial information. The staff thinks that at the June meeting there was agreement amongst Board members that some of

the possible amendments, for example measuring allowances at fair value through profit or loss, would have improved IFRIC 3. However, the Board decided against addressing issues individually because it concluded that it would need to look at all of the key issues together.

83 Therefore, the staff view is that it will be possible to develop an alternative solution to IFRIC 3 that will improve relevance, reliability, understandability and comparability in financial reporting and that will command sufficient Board support and approval. Even in the unlikely event that the Board were to be unable to resolve the accounting for allowances issued by government and had to leave the existing IAS 20 in place, alternatives have already been developed that, in the staff's and IFRIC's view, would improve IFRIC 3.

Cost/benefit considerations

84 The output of this project should benefit users by increasing the transparency and comparability of the financial information of participants in emission trading schemes.

85 However, for most entities that participate in schemes in which the allowances are traded in active markets, the staff does not foresee significant increased accounting costs. This is because entities already have to record and report emissions to comply with the scheme rules. And in the EU ETS, allowances are recorded in registries. Therefore, generating the accounting information if it is based on market values should not require complex system modification or result in major ongoing costs.

Feasibility

86 The staff thinks that having narrowed down the issues to be addressed in the project, it should be possible to develop solutions in a reasonable time period.

87 The project is likely to depend on another project—the IAS 20 amendments. We think that the issues raised by tradeable permits issued by government need to be considered within the context of the work already started on IAS 20. As discussed in the project plan below, the staff thinks that the two projects should be run concurrently.

Resource constraints

Availability of expertise outside the IASB

88 The staff notes that other standard-setting bodies have considered the topic. For example, a technical committee of the ASBJ is currently examining the topic of emissions trade; the Australian UIG, in monitoring the IFRIC's work, has considered renewable energy certificates; the AcSB has a research project considering the accounting implications of the proposed Canadian scheme; and the Spanish Accounting and Auditing Institute is considering the EU ETS. There is also the recent work undertaken by the EFRAG staff. Therefore, the Board will be able to consider international research on this topic.

89 In addition, the Board should note that the International Emissions Trading Association (IETA) has been supportive of the staff in the past and has taken a keen interest in accounting developments in this area, hosting a number of conferences. It is therefore likely to be another useful and important research source.

Amount of additional research required

90 In paragraphs 31-67, the staff has proposed the issues to be addressed in the project. The staff believes that in the light of IFRIC's work sufficient research has been undertaken on these issues to form the basis of starting the project. (We note, however, that more research work needs to be undertaken, particularly on national accounting developments in accounting for tradeable permits as well as national accounting more generally for other permits and similar assets issued by governments for no consideration.)

Availability of IASB resources

91 Staff resources at the IASB are currently scarce. In particular, the Board should note that the staff member who worked on the IFRIC project is not available to start work on this project on a full time basis.

92 However, the IASB is recruiting additional staff, and the possibility of this project has been reflected in the Directors' staffing plans.

93 Therefore, the Directors' view is that this is a project that can be undertaken within current planned resources.

Conclusion

94 The staff view is that the proposed project satisfies the Board's criteria for adding a project to its technical agenda.

Project plan

Interaction with IAS 20 project

95 As discussed in paragraphs 40-52, an emissions trading project would interact with the Board's project to revise IAS 20. Indeed, if the Board adds emissions trading to its agenda, the staff does not think that the Board can proceed with its IAS 20 amendments as planned without first considering their ramifications on emission trading schemes. We think that the topic of emissions trading has highlighted an important general issue for the IAS 20 project, namely the treatment of licences, quotas, and similar assets that governments grant entities for no consideration. Only when this issue has been considered generally can the Board consider the more specific issue of tradeable permits that arise in emission trading schemes.

96 Accordingly if an emissions trading project is added to the agenda, the staff thinks that it needs to run concurrently with the IAS 20 project.

97 We also think that if the Board agrees with our suggested scope and project outputs as discussed in paragraphs 20-67, the IAS 20 ED should be issued simultaneously with any other ED from this project.

98 This therefore means delaying the IAS 20 ED, which is currently scheduled for issue later this year. The Board should note that some constituents (eg Australia and New Zealand) view the IAS 20 amendments are as important and long overdue in their own right. Therefore, in view of this, and in view of the desirability of completing the emissions trading project before 2008 (ie the start of the Kyoto Protocol's first commitment period), the staff recommends that the project commence as soon as staff resources permit.

Proposed project plan

99 If the Board decides to add emissions trading to the agenda and agrees with the staff's proposed scope, the staff proposes addressing the issues as follows:

Meeting	Topic
1	Education session on the various types of emissions schemes (to be undertaken in conjunction with scheme experts).
1	Consideration of whether a tradeable permit is an asset and whether this conclusion is affected by how the permit is acquired. This includes a consideration of the nature of a tradeable permit, for example is it a licence to emit or is it a form of emission currency.
2	IAS 20 project: recap decisions to date. Revisit and refine decisions about the definition of a conditional government grant. This includes a consideration of whether the revised IAS 20 should converge with the principles in SFAS 116 *Accounting for Contributions Received and Contributions Made*
3	IAS 20 project: recognition and measurement of licences, quotas and similar assets issued by government for no consideration.
4	Consideration of the accounting treatment for tradeable permits issued to entities by government free of charge. What is the initial accounting?
5	Consideration of the appropriate accounting subsequent accounting for tradeable permits. Are the existing models in IAS 38 and IAS 39 appropriate for these assets? If not, how can they best be amended? Overall consideration of the effects of reporting the changes in assets and liabilities under the above decisions.

100 If a target date of July/August 2007 is set for final Standards arising from this project (so that they are available in time for the start of the Kyoto Protocol's first commitment period), the staff estimates that the project would need to commence in the first quarter of 2006.

101 However, the view of the Directors is that this project should not be started until the appropriate staff resources are available.