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**International
Accounting Standards
Board**

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INFORMATION FOR OBSERVERS

Board Meeting: 20 May 2008, London

Project: Emissions Trading Schemes

Subject: Cover note (Agenda paper 03)

PURPOSE OF THIS MEMORANDUM

1. In May 2008, the staff plans to ask the Boards to clarify the scope of their joint project on emissions trading schemes. There are three main reasons for the staff's request:
 - a. The accounting questions that will need to be answered (and therefore the staff's direction of research) depend on the scope of the project.
 - b. Neither Board clearly defined the scope (in light of the variety of schemes that exist) when it added the project to its agenda.
 - c. An opportunity exists to align each Board's respective scope.
2. This memorandum describes the various types of emissions trading schemes and other tradable rights¹ of which the staff is aware. It also describes the accounting questions associated with each type of scheme or tradable right that the staff believes will need to be addressed. In this memorandum, the staff recommends that the Boards set the scope of this project broadly to address all of the accounting questions related to the various schemes and tradable rights described herein. The staff notes that there is a strong

¹In this memorandum, *tradable rights* is used as a general term encompassing the variety of instruments (allowances, credits, and certificates) that may be remitted to fulfill an obligation under an emissions trading scheme.

demand among the Board's constituents, particularly preparers, for answers to these questions.

INTRODUCTION

3. The staff has been researching emission schemes and has identified the accounting issues that arise as a result of the various schemes. Presently, there is no authoritative accounting literature in either IFRS or U.S. GAAP that addresses these issues. Both the IFRIC and the EITF have previously considered the accounting for emissions trading schemes, but neither issued guidance that was implemented in practice.
4. In June 2005, the IASB withdrew IFRIC 3, Emissions Rights, which addressed the accounting for the rights and obligations arising from participation in the European Union's Emissions Trading Scheme (EU ETS). 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. IFRIC 3 was criticized by constituents because of its effect on the income statement. In particular, constituents were concerned about the mismatch that arises when allowances are revalued through equity but revaluation of the corresponding liability is recognized in the income statement. Additionally, constituents objected to the mismatch in the timing of income and expense recognition. Although IFRIC 3 was withdrawn, several IASB Board members indicated at that time that they believed it properly interpreted existing IFRS standards.
5. The EITF discussed the accounting for emissions trading schemes in EITF Issue No. 03-14, "Participants' Accounting for Emissions Allowances under a 'Cap and Trade' Program," but did not reach a consensus. The EITF decided to discontinue discussion of the issue, with Task Force members citing the following concerns:
 - a. Any conclusions reached might have broader implications on the accounting for government licenses and permits.
 - b. The accounting model might call for immediate gain recognition upon receipt of an allowance, with the cost being recognized subsequently as an expense.
 - c. There did not appear to be diversity in practice among U.S. constituents.
6. The U.S. Federal Energy Regulatory Commission (FERC) has issued accounting guidelines for entities that are subject to its oversight to follow in their regulatory financial statements. Those guidelines include specific guidance on accounting for

emissions allowances. The staff believes that, in the absence of authoritative U.S. GAAP pronouncements, entities regulated by the FERC apply the FERC guidance on emissions allowances in their general purpose financial statements, which explains the apparent lack of diversity noted by Task Force members.

7. For the most part, the questions that arose in the staff's recent research are not different from the questions that the IFRIC considered when deliberating IFRIC 3. However, there are additional schemes and accounting implications that should be considered.

Description of the Types of Schemes

8. Schemes designed to reduce emissions of greenhouse gases and other pollutants into the air and water through the use of tradable emissions rights—emissions trading schemes—are a relatively recent phenomenon, although the concept of using a tradable right 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 five percent below 1990 levels over the period 2008–2012.
9. The theory behind emissions trading relies on the creation of value through the allocation of a right to emit. An emissions target is set and distributed (either through an auction or through allocation) among those that qualify. The emissions target creates a “cap” or a “baseline” target of total emissions allowed during a particular period. This target is normally below actual physical levels of emissions currently being made by entities. Hence, an artificial scarcity is created, which in turn creates a value for the holders of such rights.
10. Emissions trading schemes are believed to reduce emissions in a manner that is cost effective and efficient. Entities participating in the scheme that can reduce emissions without significant cost have an economic incentive to do so, by virtue of their ability to sell their excess tradable rights to other entities whose costs to reduce emissions are higher. In this way, resources are reallocated within the broader economy to those entities that can reduce emissions with the lowest cost, resulting in the desired overall level of emissions reductions with the lowest total cost to the emitting entities as a group.

11. Many schemes allow for additional flexibility mechanisms to lower the overall costs of achieving the emissions targets. These mechanisms often involve projects to reduce emissions from sources that are not subject to an emissions trading scheme. Entities that complete such projects receive certificates that may be traded and used like a scheme's standard allowances. However, most schemes set limits on the number of certificates that may be remitted in lieu of those allowances. Other tradable rights have evolved outside of emissions trading schemes, for example, certificates representing a unit of electricity generated from an eligible renewable energy source.
12. The following sections describe the basic characteristics of the significant emissions trading schemes and other tradable rights that exist today, based on the staff's research:
 - a. Cap and trade schemes [¶13–¶22];
 - b. Baseline and credit schemes [¶23–¶27];
 - c. Project-based certificates [¶28–¶35];
 - d. Renewable energy certificates [¶36–¶40].

Additionally, separate sections address voluntary schemes [¶41–¶46] and trading activities [¶48–¶51].

Cap and Trade Schemes

13. In a cap and trade scheme, a central authority (for example, a government or agency thereof) sets an overall cap on the amount of emissions that may be released in a specified compliance period. This cap is then allocated to entities by distributing “allowances to emit,” each allowance granting a right to emit one ton of CO₂ (or other greenhouse gas). The cap is initially set below historical levels of entities' emissions in a baseline period prior to the inception of the scheme and is reduced further over time. Under most schemes, governments currently issue the majority of the allowances to emit free of charge to the participants. In other schemes, entities may be required to purchase allowances from the government (for example, through government auctions). Some schemes use a combination of methods for the initial distribution of allowances. Over time, it is expected that fewer allowances will be issued free of charge and more will be allocated through government auction.
14. Schemes operate over a compliance period (typically one year, but longer in some schemes), and allowances are allocated (or auctioned) to the participants usually at the

beginning of each compliance period. However, in some schemes, the government may issue allowances spanning multiple compliance periods (years) all at once. After allowances are issued, participants may buy or sell them directly with other participants or, depending on market sophistication, through a broker or on an exchange.

15. After each compliance period ends, it may take several months to make a final determination of each participant's emissions ("true-up period"). Once this determination is made, each participant must settle its obligation under the scheme by remitting emissions allowances equal to its actual emissions for the period. If a participant fails to do so, there may be multiple variations of consequences depending on the scheme. Some of the penalties include paying a fine, being required to remit the deficient quantity of allowances in the subsequent period, and receiving a smaller allocation of emissions allowances in the future. In some schemes, unused (or excess) allowances may be carried forward ("banked") for use in future compliance periods.
16. As a result, for a compliance period, a participant has three options:
 - a. It may emit to the level of its allocated allowances.
 - b. It may emit to a lower level than is represented by the allocated allowances, and it may sell or bank the excess allowances.
 - c. It may emit to a higher level than is represented by the allocated allowances and buy additional allowances (or, in some schemes, pay a penalty).
17. In the extreme, a participant may sell all of its allowances at the beginning of the compliance period with the expectation of either (a) buying allowances to cover its emissions at a later date or (b) ceasing emissions.
18. Brokers and other non-participants typically may buy and sell emissions allowances. The participation of these other parties may increase the liquidity of the market for the allowances. See further discussion of broker and dealer activities under the heading "Trading Activities" [¶48-¶51].
19. An example of a cap and trade scheme is the EU Emissions Trading Scheme (EU ETS). This is the largest company-level, multi-sector cap and trade emissions trading scheme in the world. Several other schemes exist as well, such as the Acid Rain Program established in the United States under the 1990 Clean Air Act. Additionally, more schemes have been proposed for implementation. For example, there is a bill under

consideration by the Environment and Public Works Committee of the U.S. Senate (S. 2191) that proposes to institute a national carbon-based cap and trade emissions trading scheme in the United States.

20. The staff believes that government mandated cap and trade emissions trading schemes are the most common type of scheme in the world today. The staff also believes that most of the key accounting issues to be addressed related to cap and trade schemes are also relevant to other schemes. Some of the key questions that need to be addressed in cap and trade schemes include:

- a. Is an allowance an asset? If so, what is the nature of that asset?
- b. How should an allowance be initially recognized and measured, particularly if it is received from a government for less than fair value (for example, allocated free of charge)?
- c. If the Boards conclude that allowances received free of charge should be measured initially at fair value, rather than at historical cost, what is the accounting for the credit, both initially and subsequently (for example, recognize in profit or loss immediately or at a later time)?
- d. When should an entity recognize allowances if the entity is notified by the scheme administrator that it will receive allowances in the future (upon notification, upon actual receipt, or at some other point)?
- e. How should allowances be accounted for in subsequent periods?
- f. Should the selection of the measurement attribute be affected by the liquidity of the market or the availability of quoted market prices?
- g. When should a liability for the obligation to remit allowances to the government be recognized?
- h. How should that liability be measured initially and subsequently?
- i. What is the appropriate timing and overall effect on profit and loss recognition?
- j. How should the assets, liabilities, income, and expenses be presented in the financial statements? In particular, when, if ever, is it appropriate to net allowances with the liability for the obligation to remit them to the government?
- k. What disclosures should be required?

Vintage Year Swaps

21. A common transaction in U.S.-based cap and trade schemes that does not occur in the EU ETS is a vintage year swap. In the United States, typically each individual allowance has a vintage year designation (that is, the year an allowance may be used). A government may, all at once, issue allowances spanning multiple vintage years (for example, by issuing allowances with vintage years from 2008 to 2012 at the beginning

of 2008). An allowance may not be used before its respective vintage year designation but, in some schemes, may be carried forward and used in future operating years.

22. An example of a vintage year swap that one might observe in the marketplace is summarized as follows:
 - a. Company A has excess allowances for the upcoming compliance year (2008) but anticipates needing additional allowances for 2010.
 - b. Company B has an opposite exposure. It needs additional allowances for the upcoming year but forecasts that it will have excess allowances for 2010 based on its planned addition of emissions control equipment to its generating facilities.
 - c. Company A and Company B decide to swap allowances. Company A delivers 2008 allowances to Company B in exchange for 2010 allowances. The transaction may or may not include a cash element.

The accounting issue that arises is whether the swap should be accounted for at fair value or based on the recorded amount.

Baseline and Credit Schemes

23. In a baseline and credit scheme, each source participating in the scheme is assigned a specific emissions limit for a period. This limit is typically based on historical emissions, and it may vary based on the source's level of output (that is, the higher a source's output of electricity in a year, the higher the emissions limit for that source in that year). After the relevant period has ended, each source's actual emissions are compared to its limit. If the source has emitted less than its limit, it receives credits in the amount of the difference. If a source has emitted more than its limit, it must buy credits from sources that were below their limit to offset the excess emissions. In some schemes, credits expire if unused; in others, they may be banked for use in future years. Some schemes allow participants flexibility, for example, by engaging in project-based activities or by paying into an environmental fund to make up for a shortfall in remitted credits (similar to a penalty payment).
24. Generally, markets for credits in baseline and credit schemes, all other things being equal, are not as robust as they would be in cap and trade schemes regulating the same emissions in the same jurisdiction. The credits typically exist and are traded over a much shorter period of time (for example, over a period of a few months during a period that follows the relevant compliance period). Additionally, the number of credits

that exists in a baseline and credit scheme is significant fewer than would exist in a cap and trade scheme regulating the same emissions.

25. The differences between a baseline and credit scheme and a cap and trade scheme highlight important issues about accounting for the liability that arises from emissions. A participant in a baseline and credit scheme is not required to remit allowances for its entire emissions, rather only for the portion of its emissions that exceeds its specific limit for the period. Should a liability be recognized before a participant exceeds its emissions limit for the period (perhaps using a model similar to that for contingent rent under EITF Issue No. 98-9, “Accounting for Contingent Rent”)? For example, suppose an entity is allocated a baseline of 100 tons of emissions per year. Halfway through the year, the entity has emitted 60 tons and expects to emit another 60 tons in the second half of the year. Should the entity recognize a liability and expense corresponding to 10 tons of emissions?
26. By contrast, in a cap and trade scheme, a participant must remit allowances for its entire emissions. However, entities typically receive those allowances from the government free of charge and simply remit them back to the government. Some might argue that the allowances in a cap and trade scheme are akin to a limit in a baseline and credit scheme and that the accounting should be the same (that is, a liability should be recognized only for emissions in excess of allowances held). If baseline and credit schemes are included in the scope of the project, Board members will need to consider how their views on the accounting for baseline and credit schemes affect their views on the accounting for cap and trade schemes.
27. Another question that would need to be considered is the timing of recognizing credits. If an entity is reasonably sure that its emissions will be below the baseline, may it recognize an asset before the credits are issued? If so, what is the appropriate measurement attribute? If an entity incurs incremental costs to reduce emissions in contemplation of receiving credits at the end of the compliance period, may it capitalize those costs as an asset?

Project-Based Certificates

28. Many of the emissions trading schemes described above allow for project-based mechanisms. This creates flexibility for participants in meeting their emissions targets

and reducing global emissions. These mechanisms often are only supplemental to domestic action and cannot be a significant element of the emissions reductions. Under the Kyoto Protocol, domestic action must make up the majority of a country's total emissions reduction efforts.

29. In the proposals for Phase III of the EU ETS (which is scheduled to run from 2013 to 2020), project-based certificates are being phased out. It is expected that no new certificates will be granted in Phase III (except in certain limited circumstances), but that an entity would be able to carry forward the certificates that it earns in Phase II. However, emissions trading schemes other than EU ETS will continue to recognize and accept these certificates in lieu of allowances.
30. The two project-based mechanisms under the Kyoto Protocol are clean development mechanism (CDM) and the joint implementation (JI).

Clean Development Mechanism

31. This mechanism allows an entity that operates in a country with an emissions target (called an "Annex 1" country, typically a "developed" country) to carry out projects in a non-Annex 1 country (that is, a country with no emissions targets under the Kyoto Protocol). Any emissions reductions achieved in the non-Annex 1 country can then be used by an entity in an Annex 1 country to meet its own emissions obligations. The certificates received under this mechanism are called "certified emission reductions" (CERs). The creation of CERs increases the total tradable rights available to the market. Apart from reducing emissions, the CDM results in the non-Annex 1 country benefiting from advanced technology that allows a plant to operate more efficiently.

Joint Implementation

32. This mechanism is similar to the clean development mechanism, however, it is between two Annex 1 countries (that is, two countries with allocated emission targets). Projects are carried out by an entity from one Annex 1 country in another Annex 1 country, and any emissions reductions (called "emissions reductions units" (ERUs)) are received by the party paying for the project. For example, an entity from a Western European country might build a facility in the former Soviet Union. The entity from the Western European country receives certificates, and the country in the former Soviet Union gains investment and advanced technology, but does not receive credit toward meeting

its national emissions target under the Kyoto Protocol. The rationale behind the JI mechanism is that it is often less expensive to carry out energy-efficient work in a different country and to realize greater reductions in emissions.

33. Other mechanisms are also foreseen by the Kyoto Protocol, such as removal units (RMUs). They represent reductions in the amount of greenhouse gases in the atmosphere by means of land use, land use change, and forestry activities. RMUs are not presently traded but may be in the future.
34. The certificates, i.e. CERs or ERUs, are issued only after a complex verification and certification process involving third parties at various stages. The first issuance of certificates may easily occur several years after the start of the project.
35. Assuming that the accounting for a purchased project-based certificate would be the same as for a purchased emissions allowance, the significant accounting questions about these certificates relate to the accounting by the entity undertaking the project for the purpose of either selling or using the certificates:
 - a. When does an asset exist? Should an entity recognize an asset before the certificates are issued if it is reasonably sure to receive them? If project-based related costs are expected to result in a certificate, should they be capitalized as an asset?
 - b. Suppose the Boards decide that tradable rights should be measured at fair value. What would be the implications for revenue recognition when internally generated certificates are initially recognized at fair value?

Renewable Energy Certificates

36. Tradable rights may also be granted to an entity that generates electricity from eligible energy sources. These rights are generally known as renewable energy certificates (RECs) but are also called green certificates, green tags, or tradable renewable certificates. They are a mechanism to motivate industries to increase the amount of power generated from renewable energy sources.
37. In parts of the United States, a compliance market for renewable energy sources has been established. Typically, a state regulatory agency (for example, the Board of Public Utilities in New Jersey) requires entities under its jurisdiction to remit RECs representing a percentage of the electricity they sell into the retail market. Eligible

renewable energy sources (solar, wind, geothermal, methane gas, hydroelectric, waste, and heat recovery) are certified by the state.

38. Each state program has an annual compliance period with a true-up period to settle their obligation to remit RECs. Similar to allowances, the RECs are traded in a secondary market. In lieu of remitting the required RECs, an entity may make an Alternative Compliance Payment (ACP). This penalty effectively establishes a cap on the price of the certificates.
39. To obtain RECs, an entity may choose to do any of the following:
 - a. Generate electricity from an eligible renewable energy source itself;
 - b. Purchase RECs packaged with the underlying renewable source electricity from another entity; or
 - c. Purchase RECs without the underlying electricity on the open market.
40. Entities that generate electricity from eligible renewable energy sources face similar accounting questions as entities that undertake projects to generate project-based certificates. Should they recognize an asset before the certificates are issued? If so, should that asset be measured at cost or fair value? Additionally, entities that purchase RECs packaged with the underlying electricity have requested guidance on how to allocate the cost between those two elements.

Voluntary Schemes

41. Most emissions trading schemes are government mandated; however, voluntary schemes also exist. Voluntary schemes generally are similar to government mandated cap and trade or baseline and credit schemes in most respects. The significant difference appears to be the nature of the obligation. In a government mandated scheme, entities are required to participate by law, and the government has the right to enforce participation and compliance. In a voluntary scheme, participants enter into a legally binding contract with the scheme administrator (a non-governmental entity) to achieve emissions reductions in future years compared to their historical emissions. The penalty for non-compliance is governed by contract law, and disputes are settled, if necessary, in civil court.
42. Chicago Climate Exchange (CCX) is the largest voluntary emissions trading scheme in the world today. In essence, CCX works like a government mandated cap and trade

scheme. Each participant is allocated annual allowances in accordance with its emissions target. The allowances may be used to offset emissions obligations, banked, or sold to another participant. However, CCX allowances may not be used in other schemes, and other schemes do not accept CCX allowances. Similar to the Kyoto mechanism, CCX also allows members to engage in project-based activities to meet their obligations.

43. CCX includes in its scheme two approaches for reducing indirect emissions. Regular members may opt into a baseline and credit mechanism tied to their energy consumption. Additionally, office-based businesses or institutions with negligible direct emissions that wish to market themselves as “green” may apply for membership. Those members do not receive any allocated allowances; rather, they commit to offset their entire indirect emissions during a period by buying and retiring a corresponding number of allowances.
44. The staff notes that it is possible that voluntary schemes may disappear as more government mandated programs are implemented. However, due to the political uncertainties inherent in passing such legislation into law, it is possible that voluntary schemes could continue to grow in importance, especially if political gridlock ensues and the private sector feels compelled to act in response.
45. The effectiveness of voluntary schemes is often criticized for having emissions reductions targets that are too easy to achieve and for failing to attract participants. The former may explain why the staff is not aware of any breach of contract in voluntary schemes. The disincentive for not complying appears to be based more on damaged reputation.
46. Some of the accounting questions that would need to be addressed if voluntary schemes are included in the scope include:
 - a. Is the nature of a participant’s rights and obligations under a voluntary scheme sufficiently similar to those under a government mandated scheme to warrant identical accounting?
 - b. Should there be a difference in the accounting for an entity’s receipt of allowances free of charge between a government mandated scheme and a voluntary (private sector) scheme? In the former case, the allocation may represent a government grant, for which authoritative literature exists under IFRS (IAS 20, Accounting for Government Grants and Disclosure of Government Assistance), but not under

U.S. GAAP. (The staff acknowledges that the IASB has told the staff not to feel constrained by the guidance in IAS 20.) In the latter case, the allocation may represent a contribution received, for which guidance exists under U.S. GAAP (FASB Statement No. 116, Accounting for Contributions Received and Contributions Made) but not under IFRS.

TRADING ACTIVITIES

48. Brokers and other non-participants typically buy and sell tradable rights in secondary markets. The participation of these other parties may increase the liquidity of the market for the allowances. The secondary market for tradable rights is quite vibrant in some (but not all) schemes and features products including straightforward sales, vintage year swaps, and bundled sales with other products such as coal. According to the World Bank's publication *State and Trends of the Carbon Market 2007*, "The EU ETS continues to be the most prominent of these markets in terms of overall volume and financial value transacted, with compliance, risk management and arbitrage being its major drivers...In its second year (2006), the EU ETS saw over one billion allowances changing hands (1,101 million representing a three-fold increase over 2005) for a financial value of US\$24.4 billion or €18.7 billion (also up slightly more than three times from US\$7.9 billion in 2005 or €6 billion)."² Some industry experts estimate that the total value of emissions trading markets will double by 2012. Many believe worldwide markets will continue to develop for the trading of allowances as evidenced by commodity brokers' and investment banks' recent investments in allowances.
49. The FASB currently has a project on its agenda to amend Chapter 4 of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, to require trading inventory to be accounted for at fair value, with changes in fair value recognized in profit or loss. Some constituents requested that the FASB clarify whether traded allowances are within the scope of that proposed FASB Staff Position. The Exposure Draft is silent on this question. IAS 2, *Inventories*, provides a scope exception from the requirement that inventory be measured at the lower of cost and net realizable value for commodity broker-traders who measure their inventories at fair value less costs to sell.
50. Depending on the answers the Boards reach on the other questions related to accounting for allowances, the Boards may wish to consider whether a different accounting model

²"State and Trends of the Carbon Market 2007," by Karan Capoor and Philippe Ambrosi, 2007, p. 11.

should apply for traded allowances or allowances held by commodity broker-dealers. In some scenarios, this question may not need to be addressed (for example, if the Boards decide that allowances should be accounted for as inventory in accordance with ARB 43, as amended by the proposed FSP, or IAS 2).

51. Other market participants include entities that purchase tradable rights for the purpose of retiring them and marketing themselves as “green.” Such entities typically estimate their total carbon-equivalent emissions (both direct and indirect) and purchase allowances equal to those emissions. They “retire” the allowances and promote themselves as leaving no “carbon footprint.” For these entities, two accounting questions arise. First, if they commit publicly to purchasing the allowances, what is the nature of that obligation and should it give rise to recognition of a liability? Second, how should they account for the cost of the allowances they purchase? On the one hand, they expect to retire them. On the other hand, if they were to experience liquidity problems, they could decide to sell those tradable rights on the open market to generate cash.

Scope Alternatives

52. Based on our research, the staff has identified three possible scopes for the project:
 - a. Alternative A—government mandated cap and trade schemes only (narrow scope).
 - b. Alternative B—all emissions trading schemes and tradable rights (broad scope).
 - c. Alternative C—a scope between the narrow scope and broad scope to be determined by the Boards.

Alternative A (narrow scope)

53. A narrow scope would limit the guidance to government mandated cap and trade emissions trading schemes. Even with this narrow scope, the Boards would need to address many significant issues, including, among others, the nature of the asset, the accounting for allowances issued free of charge, and the accounting for the liability.

Alternative B (broad scope)

54. A broad scope would include all emissions trading schemes and tradable rights. The staff would research and address all of the accounting questions included in this memorandum if the Boards support this alternative. In particular, this scope would

involve addressing the questions about whether an entity may recognize an asset related to a tradable right prior to issuance of the right (for example, whether an entity may capitalize costs related to project-based activities that are expected to result in one or more certificates).

Alternative C

55. If the Boards believe that the scope of Alternative A is too narrow and the scope of Alternative B is too broad, the Boards could direct the staff not to address some of the accounting questions that arise under Alternative B. For example, the Board could decide to exclude from the scope of the project the accounting activities or costs that may lead to being issued a tradable right (for example, project-based activities).

Staff recommendation

56. The staff recommends that this project be scoped broadly (Alternative B) for several reasons. Constituents, particularly financial statement preparers, are asking for guidance on all of these issues. The staff understands that financial statement users also prefer that the project be broadly scoped. There is no authoritative literature in IFRS or U.S. GAAP that addresses the subject; consequently, preparers are uncertain about the proper accounting and diversity has developed in practice. A survey published in 2007 “identified six main approaches applied by respondents” to account for allowances and obligations under the EU ETS.³ With regard to project-based certificates, that survey also noted that “there is no common approach for accounting for self-generated CERs.”⁴ If the Boards were to leave certain issues out of the scope, diversity in practice is likely to remain.
57. For example, for some entities that develop project-based certificates, selling the certificates may represent a revenue transaction. Others might consider the receipt of the certificates as appropriate for revenue recognition. Additionally, some entities might capitalize costs incurred during the generation of certificates in a project-based activity; others may not.

³“Trouble-entry accounting—Uncertainty in Accounting for the EU Emissions Trading Scheme and Certified Emissions Reductions,” by PricewaterhouseCoopers and the International Emissions Trading Association, 2007, p. 10.

⁴Ibid, p. 11.

58. Further, the lack of authoritative guidance might produce diversity between different schemes and/or tradable rights. For example, some entities might apply the same accounting treatment to costs incurred to reduce emissions in expectation of receiving tradable rights in baseline and credit schemes as they apply to project-based activities; others may not.
59. Another consequence of a limited-scope project might be that preparers and auditors bombard the Boards with questions about how to account for schemes or tradable rights that were excluded from the scope of the project. The staff believes it would be more efficient to address those questions now in a broad project rather than in a piecemeal fashion after issuing a narrow-scope standard.
60. Additionally, the staff notes that the number and types of emissions trading schemes continue to increase over time as more and more citizens, entities, and governments all around the world grow increasingly concerned about the environment. For this reason, the staff recommends that all schemes be included in the scope and that the guidance be based on broad principles that could be applied to a wide variety of schemes.
61. However, the staff acknowledges that a narrow-scope project likely would be completed in a more timely manner. The staff estimates that it would require one or two additional meetings by each Board prior to issuing an Exposure Draft to address the incremental accounting questions that a broad scope project would require over a narrow scope project. Furthermore, one might argue that some of the issues are not specific to emissions trading schemes. For instance, the issue about how to account for the activities that an entity undertakes in contemplation of receiving tradable rights may be dealt with through interpretative guidance once the key issues have been resolved.
62. If the Boards decide on a broad scope and resolving the incremental accounting questions begins to take more time than anticipated, the scope could be modified at that time.
63. Regardless of how the Boards scope the project, the staff recommends that the Boards establish identical scopes to assist the staff in efficiently using its resources and coordinating efforts. The level of difficulty in achieving a converged standard will, in part, depend upon the similarities or dissimilarities of each Board's decision on scope.

Staff's Proposed Description of Scope and Definition of an *Emissions Trading Scheme*

64. The staff recommends that the scope of the proposed standard be described as follows: This [Statement/IFRS] provides accounting guidance for a legal or contractual obligation arising from an emissions trading scheme as well as for tradable rights that may be remitted to fulfill those obligations. It also addresses the accounting for activities that an entity undertakes in contemplation of receiving tradable rights. It applies to all [nongovernmental, U.S. GAAP only] entities with tradable rights, regardless of whether they participate in an emissions trading scheme.

65. The staff believes that the key elements of this description are as follows:

- a. The types of assets that are within the scope are defined by the obligations they can be used to fulfill. For example, all project-based certificates are within this scope because they can be used to fulfill obligations under emissions trading schemes.
- b. The type of obligation is described as legal or contractual to clarify that both governmental and voluntary emissions trading schemes are within the scope.
- c. It covers tradable rights to distinguish them from ordinary government permits, which clearly are not intended to be within the scope of this project.
- d. The second sentence includes in the scope circumstances in which an entity expects to receive tradable rights, but those rights have not yet been issued.
- e. The last sentence clarifies that the guidance applies to all entities that hold allowances, not just entities that participate in an emissions trading scheme. (New FASB pronouncements do not apply to governmental entities.) Without this clarification, the staff believes the scope might be misinterpreted as applying only to entities that have obligations under such schemes.

66. The staff believes that this description of the scope must be supplemented by a definition of an emissions trading scheme. Accordingly, the staff proposes that an emissions trading scheme be defined as follows:

An emissions trading scheme is an arrangement designed to improve the environment, in which participating entities may be required to remit to an administrator a quantity of tradable rights that is linked to their direct or indirect effects on the environment.

67. The staff believes the key aspects of this definition are as follows:

- a. The project is intended to address schemes that are designed to improve the environment. Therefore, the staff believes it is important to include the word environment in the definition. Tradable rights that are not tied to the environment are not in the scope of this project.
- b. The obligation to remit may be related not only to an entity's own direct effects on the environment but also to its indirect effects. This aspect of the definition is

intended to capture schemes that cover an entity's indirect emissions as well as government requirements to remit tradable renewable energy certificates, which are not called schemes but have many of the same characteristics as schemes.

The staff is open to Board members' suggestions for refining the description of the scope and the definition of an emissions trading scheme during the course of the project.

Constraints of Existing Literature

68. The staff seeks guidance from the Boards about whether the accounting models it develops for the Boards' consideration should be constrained by existing authoritative IFRS and U.S. GAAP literature. For example, some have argued that the models should not be constrained by the guidance in IAS 20 on government grants even though the allocation of allowances by a government appears to meet the definition of a government grant. (As previously noted, the IASB Board has told the staff not to feel constrained by IAS 20.) Others have argued that allowances are intangible assets but should be accounted for at historical cost even though FASB Statement No. 142, Goodwill and Other Intangible Assets, states that an intangible asset should be initially measured based on its fair value. Additionally, it is known that the U.S. Securities and Exchange Commission has accepted accounting for allowances as inventory even though inventory is defined in ARB 43 as a tangible asset.
69. The staff believes that tradable allowances are unique instruments that are not contemplated by the existing bodies of IFRS or U.S. GAAP literature. Accordingly, the staff recommends that it not be constrained by existing accounting literature when developing its proposed accounting models.

Questions for the Boards

Q1: Do the Boards agree with the staff's recommendation to scope this project broadly (Alternative B)?

Q2: If so, do the Boards agree with the staff's proposed scope statement and definition of an emissions trading scheme?

Q3: If the Boards do not agree with the staff's recommendation on scope, what do the Boards believe should be the scope of this project?

Q4: Do the Boards agree with the staff's recommendation not to constrain itself to existing authoritative literature when developing possible accounting models?