Financial Accounting Standards Board

International Accounting Standards Board

401 Merritt 7, PO Box 5116, Norwalk, CT 06856, USA
Tel: +1 203 847 0700
Fax: +1 203 849 9714
Website: www.fasb.org

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

INFORMATION FOR OBSERVERS

IASB/FASB Meeting:	**21 October 2008, Norwalk**
Project:	**Emissions Trading Schemes**
Subject:	**Accounting issues (Agenda Paper 9B)**

INTRODUCTION

1 This Agenda Paper highlights the main accounting issues at the inception of emissions related cap and trade and emissions related baseline and credit schemes, specifically those related to initial recognition upon allocation of granted emission allowances or a baseline. The staff believe these issues to be among the most difficult and contentious accounting issue to address in these schemes.

2 The Agenda Paper discusses the following issues:

a In a baseline and credit scheme and in a cap and trade scheme, are credits and emission allowances assets? (¶5-¶8) b Should an entity recognise credits and emission allowances? (¶9-¶14)

c In a baseline and credit scheme, is the baseline an asset? (¶15-¶21)

d Should an entity recognise a baseline? (¶22-¶30)

e When does an entity incur an emission obligation in the schemes? (¶31-¶38)

f What is the corresponding entry on recognising a baseline and allocated emission allowances? (¶39-¶45)

g Do the schemes require consistent accounting approaches? (¶46-¶51)

h Questions for the Boards Discussion. (¶52-¶53)

3 The answers to those issues will affect the subsequent accounting. For example, if a baseline is not recognised as an asset upon assignment, to a certain extent, this will reflect upon the subsequent accounting in a baseline and credit scheme. The subsequent accounting will be considered in detail at a later stage of the project.

4 In this Agenda Paper, the staff present different views on how to address these issues. However, the staff are not asking the Boards to make any decisions at this meeting.

IN A BASELINE AND CREDIT SCHEME AND IN A CAP AND TRADE SCHEME, ARE CREDITS AND EMISSION ALLOWANCES ASSETS?

5 Both schemes introduce a trading mechanism by issuing tradable offsets in the form of emission allowances (in a cap and trade scheme) and credits (in a baseline and credit scheme). The tradable instruments are either allocated at no cost to the entities or auctioned in the market place.

6 In a baseline and credit scheme, it is likely that the credits that are issued at the end of the compliance period meet the definition of an asset under both Boards' conceptual frameworks. The existence of an asset is evidenced by the fact that a credit is a tradable right that typically has a market value and that the entity can either sell or use to settle an obligation. The future economic

benefit of the credits flows to the entity either through the exchange for other assets or the settlement of an emissions obligation.

7 Similarly, an emission allowance issued under a cap and trade scheme most likely satisfies the asset definition under both Boards' conceptual frameworks. Namely the allowance is *'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.'*

8 The existence of an asset is evidenced by the fact that an allowance is a tradable right that has a market value and that the entity can either sell or use to settle an obligation. The future economic benefit of the allowances flows to the entity either through the exchange for other assets or the settlement of an emissions obligation.

SHOULD AN ENTITY RECOGNISE CREDITS AND EMISSION ALLOWANCES?

9 Credits and emission allowances meet the definition of an asset in both Boards' conceptual frameworks. As regards recognition, most credits and emission allowances will meet the criteria for recognition. An entity controls the emission allowances and, hence, future economic benefit associated with those instruments is expected to flow to the entity. In schemes with active markets, quoted market prices provide entities with a reliable measurement of the value of emission allowances.

10 As a result, credits and emission allowances meet the recognition criteria in both Boards' conceptual frameworks.

11 In addition, there is little doubt that an entity purchasing an emission allowance in the market would report that emission allowance as an asset rather than recognise the cost as an expense. The purchased emission allowances an entity holds are indistinguishable from allocated ones, so not recognising allocated allowances (or recognising them at nil cost) would mean treating like items differently.

12 Further, if credits or emission allowances are not recognised then another set of accounting issues will arise relating to the trading of those credits or emission allowances. For instance, until the credits or emission allowances are surrendered, an entity may trade them. As evidenced by the market activity in the EU ETS, entities actively engage in trading activities.

Recognition of future instalments

13 A related issue is the recognition of future instalments. Emission allowances often are *allocated* for a commitment period covering a number of years, but *issued* in yearly instalments covering the respective compliance year. In the EU ETS, for example, the national allocation plans determine the yearly instalments for the entire commitment period (2008 to 2012). Generally, the receipt of future instalments is conditional only upon a plant continuing its operations. The allocation plans have been approved by the EU, making future changes to the plans highly unlikely. Indeed, the staff understand that were the plans to change, an affected emitter could take legal action against the relevant scheme administrator.

14 Although remote, there is a chance that an entity may not receive the emission allowances. Therefore, one view is that an entity recognises an asset for future instalments once the condition to receive them is resolved. Another view is that the allocation of allowances for future compliance years gives the holder an option to claim future instalments. Under that view, that option—the right to receive emission allowances in the future—meets the criteria for recognition as an asset.

IN A BASELINE AND CREDIT SCHEME, IS THE BASELINE AN ASSET?

15 In a baseline and credit scheme, the scheme administrator regulates the consumption of a resource that hitherto has not been restricted. This is no different from some of the intangible assets mentioned in IAS 38 *Intangible Assets*, eg airport landing rights, licences to operate radio or television stations, import licences or quotas or other rights that give access to restricted resources.

16 In the IASB's *Framework*, an asset 'is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.' Further, 'the future economic benefit embodied in an asset is the potential to contribute to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.'

17 The staff do not believe that the differences in the definitions within both Boards' conceptual frameworks would result in different answers. FASB's Concept Statement 6 defines assets as 'probable future benefits obtained or controlled by a particular entity as a result of past transactions or events.' The discussion of probable future benefits is consistent with the discussion in the IASB's *Framework*.

18 The allocation of a baseline allows a participant to perform an activity (ie emitting) up to a specified limit at no incremental cost. Only if an entity exceeds its baseline must it offset its emissions by surrendering credits (for the excess). Therefore, a baseline can be viewed as giving rise to future economic benefits to the entity because it gives the entity the right to emit up to the baseline without paying for those emissions. Without the baseline, the entity would have increased costs for *all* of its emissions. Hence, one view is that the baseline is an asset under both Boards' conceptual frameworks.

19 On another view, whether a baseline meets the definition of an asset depends on the type of scheme, specifically whether it is an 'open' or a 'closed' scheme. As discussed in Agenda Paper 9A, in an open scheme the scheme administrator provides a 'new entrant reserve'; a closed scheme has no such reserve. Generally, an entity's future economic benefit is expected to increase with the level of baseline it receives. However, the access of others to a resource also affects an entity's control over that resource. The preclusion or limitation of access by others to an economic resource demonstrates an entity's association with that economic resource.

20 In an open scheme, each new entrant to the industry has access to a baseline. Therefore while the baseline allows an entity to emit up to the level of the baseline, and thereby in theory reduces future cash outflows, it seems to have little economic value to the entity in the sense that access to a baseline is not restricted or limited. A participant has something that anyone can possess by simply applying for it. The assignment of a baseline is just a formal act. For instance, in a business combination, an acquirer would presumably pay the same price for the entity in an open scheme with or without the baseline. Therefore, under this view, a baseline does not enable the entity to preclude or limit the use of the economic resource by others. Hence, a baseline in an open scheme does not meet the definition of an asset.

21 In contrast, in a closed scheme, the scheme administrator has provided baselines only to a limited number of entities. Hence, access to the baselines is restricted or limited. Usually, the assignment of a baseline is based on past history, ie an entity that has emitted in the past is entitled to a baseline. The restricted access provides a participant with a resource that is scarce and that only a limited number of entities possess. Hence, an entity with a baseline in a closed scheme is in a different position to an entity without a baseline. The baseline is a resource from which future economic benefits are expected to flow to the entity. For instance, a restricted baseline may result in result in lower cash outflows compared with an entity with no baseline. In addition, in a business combination an acquirer would presumably pay a different price for the entity with or without the baseline. Therefore, under this view, a baseline in a closed scheme meets the definition of an asset.

SHOULD AN ENTITY RECOGNISE A BASELINE?

22 A baseline that meets the definition of an asset should be recognised if it satisfies the criteria for recognition. Under the IASB's *Framework*, a baseline should be recognised as an asset 'if:

a it is probable that any future economic benefit associated with the item will flow to or from the entity; and

b the item has a cost or value that can be measured with reliability.'

23 In most cases it will be evident that any future economic benefit associated with the baseline will flow to the entity because the baseline is linked to a specific emitting source of the entity (ie a specific plant). As long as an entity controls the emitting source it will benefit from the potential to produce emissions up to the level of the baseline at no additional cost.

24 As to measurement, baselines are generally granted for free. Hence, if they were recognised at cost they would in effect not be recognised. But, some argue that it may not be possible to measure a baseline with reliability. Unlike the tradable instruments (ie emission allowances, credits) resulting from the schemes that are actively traded in many schemes, the baselines in a baseline and credit scheme may not be traded. Hence, an active market for baselines will most likely not exist. In theory, the value of a baseline might be derived from the spot or forward prices of credits. However, the range of fair values may be significant.

25 If a baseline meets the recognition criteria there are different views on whether it gives rise to the recognition of a *separate* asset. Generally, the baseline is inextricably linked to the emitting source. An entity can neither sell a baseline separately nor acquire additional baselines.

26 One view is that, upon assignment, the baseline becomes an integral part of the emitting source it is linked to. This is similar to the example of computer software for a computer-controlled machine tool that cannot operate without that specific software in IAS 38. In the example, the specific software is treated as property, plant and equipment. Only when the software is not an integral part of the related hardware is the computer software treated as an intangible asset. Therefore, this view concludes that a baseline does not give rise to the recognition of a separate asset but becomes an integral part of the emitting source.

27 Another view focuses on whether a baseline would be recognised separately from goodwill in a business combination. IAS 38 requires an intangible asset to be identifiable to distinguish it from goodwill. An intangible asset is identifiable when it is separable or it arises from contractual or other legal

rights, regardless of whether those rights are transferable or separable. A baseline is not separable; however, it arises from legal rights, and therefore it is identifiable. Hence, in a business combination, a baseline would be recognised separately from goodwill.

28 Similarly, outside the context of a business combination, a baseline could also be recognised as a separate intangible asset when assigned (if it meets the asset definition and the other recognition criteria (ie future economic benefits flow to the entity, reliable measurement). In contrast to paragraph 26, this view does not link the baseline to specific resources of an entity.

29 However, the recognition of a baseline may be counterintuitive in some cases, as it does not reflect the entire effect of a scheme on an entity's resources. The introduction of a scheme changes the environment an entity operates in and therefore affects the entity's other resources. Some view this change in environment as the result of a business opportunity or risk. The introduction of a scheme is likely to have an adverse effect on some entities. For example, it may result in a significant increase in future costs and perhaps result in an impairment either of recognised assets or of unrecognised assets, including internally generated goodwill.

30 Recognising a baseline may not be consistent with the accounting for other similar intangible assets where a government restricts the use of a (public) good and allocates rights to use this good (for instance airport landing rights, licences to operate radio or television stations, import licences or quotas. This is because such assets are often not recognised outside of a business combination. However, in IAS 38 non-recognition arises because of the application of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. This permits an entity to recognise such assets at a nominal amount, ie nil. The IASB specifically stated that IAS 20 should not be a reference standard for this project.

WHEN DOES AN ENTITY INCUR AN EMISSION OBLIGATION IN THE SCHEMES?

31 A liability to deliver credits or emission allowances does not arise before an entity starts emitting. Until an entity starts producing emissions, it has no present obligation to surrender credits or emission allowances to the administrator under either scheme. In other words, there is no obligation to deliver allowances when an entity is allocated either emission allowances in a cap and trade scheme or a baseline in a baseline and credit scheme. A present obligation is a key characteristic of both Boards' definition of a liability: 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits' (IASB) and 'probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions of events' (FASB).

32 The fact that an entity cannot have an obligation before emitting seems to be no different from an environmental clean-up liability. The Boards have previously concluded that entities do not have clean-up liabilities until they have caused environmental damage.

33 At a June 2008 FASB Board meeting, discussions were held to determine when statutes, laws, and regulations give rise to a liability and how to deal with uncertainty when ascertaining the existence of a liability. The Board decided that an entity does not have a present unconditional obligation for future actions it expects or intends to take but cannot be compelled to take. The Board also decided that if an entity is uncertain about whether a liability exists, that entity should make a neutral judgment based on its understanding of the facts and circumstances at the end of the reporting period.

34 At that meeting, one FASB Board member expressed concern about the environmental obligation example. Specifically, this Board member felt that it was inappropriate for an entity not to recognize a liability until the entity had emitted carbon dioxide in excess of the specified limit. A similar issue arises in a pension plan with benefits that vest after a specified period. One Board

member suggested that applying judgment to the uncertainty surrounding the enforceability of the employer's promise may lead the employer to conclude that a present unconditional obligation exists prior to the vesting date.

35 However, once the entity starts to produce emissions, the timing of when an obligation arises depends on the nature of the scheme.

36 In a baseline and credit scheme, an entity incurs a present obligation when its emissions exceed its baseline. In a scheme with a fixed baseline, a present obligation arises only when an entity's overall emissions exceed the level of the allocated baseline.

37 However, under another view an entity recognises a liability in a baseline and credit scheme before its emissions exceed the baseline (ie using a model similar to that for contingent rent under EITF Issue No. 98-9, 'Accounting for Contingent Rent'. This requires a lessee to recognize contingent rental expense prior to the achievement of the specified target that triggers the contingent rental expense, provided that achievement of that target is considered probable). For example, suppose an entity is allocated a baseline of 100 emission units per calendar year, and the entity's fiscal year ends on 30 June. At the end of the fiscal year, the entity has emitted 60 units during the current compliance year and expects to emit another 60 units from July to December. Under this view the entity recognises a liability and expense corresponding to 10 units of emissions as of 30 June.

38 In a cap and trade scheme, a present obligation arises when an entity actually emits, ie an entity starts incurring a liability with the first unit of emissions.

WHAT IS THE CORRESPONDING ENTRY ON RECOGNISING A BASELINE AND ALLOCATED EMISSION ALLOWANCES?

39 If a baseline in a baseline and credit scheme is recognised as an asset, this raises the issue whether there is a corresponding liability to recognise. The same issue arises in cap and trade scheme upon recognition of granted emission allowances.

40 One view focuses on the fact that an entity has no present obligation upon recognition of a baseline or granted emission allowances. This view refers to the discussion above in paragraphs 31-38 on when an entity incurs an emission obligation under the schemes. Upon recognition of a baseline or granted emission allowances, an entity has no present obligation to remit the baseline or the emission allowances. The administrator could not fine or make the emitter take action to offset any future emissions. Although, an entity expects to emit in the future, it nonetheless has choices. For example, it could stop operating its carbon-emitting plants. A participant that stops producing usually has no obligation to remit the allocated emission allowances.

41 The likelihood that the entity will produce emissions in the future creates a risk that the entity may have to deliver credits or emission allowances in the future. However that risk does not create a present obligation.

42 Another view opposes recognizing a gain upon allocation of baseline and emission allowances. It points to the motivation behind implementing such schemes. Emissions trading schemes are a regulatory approach to reduce emissions over time by imposing costs to emit (through market based mechanisms, rather than direct fees or penalties). The free allocation of baselines and emission allowances is intended to ease the transition to a new environment for the entities. Generally, the level of baselines and allocated emission allowances is below historic emissions and is expected to decreases over time. Hence, overall the scheme will typically have an adverse affect on an entity that will increase over time. The recognition of a gain on initial receipt of credits or emission allowances does not reflect the overall purpose of an emissions trading scheme.

43 Further, a gain upon initial recognition may be counterintuitive:

a A large gain resulting from the allocation of a baseline and emission allowances is likely to be an indicator for high future compliance costs. The allocation, typically, is intended to cover a specified percentage (less than 100%) of future emissions. Hence, the overall adverse effect for a company tends to increase with the level of granted emission allowances. Put differently, some argue that it may be misleading to recognise that gain at a time when the entity does not recognise a corresponding impairment of an unrecognised asset (goodwill).;

b Profit or loss figures are difficult to compare with those of entities not operating under a scheme.

44 This view compares the allocation to a performance related grant. Only if an entity reduces its emissions, will it benefit from the schemes. An entity that has emitted in the past has limited choices. For example, most utilities enter into long-term contracts with their customers. Typically, they have sold the majority of their next year's production. Additionally, utilities are often required by the government to deliver energy. In practice, an entity that stops operating its carbon-emitting plants must provide for energy from third parties. In that situation, an energy buyer pays indirectly for the costs of emitting. Therefore, this view does not consider it appropriate to recognise a gain upon receipt of the grant if the entity knows that subsequent emissions will cause this gain to reverse.

45 Under this view, an entity recognises both baseline/allocated emission allowances and a corresponding liability reflecting the level of emissions covered by the baseline or the allocated emissions allowances initially at fair value. Alternatively, the entity recognises a baseline and allocated emission allowances initially at a nominal amount, ie nil. In the EU ETS, the accounting for allocated emission allowances at a nominal amount is applied by the majority of the big emitters.

DO THE SCHEMES REQUIRE CONSISTENT ACCOUNTING APPROACHES?

46 The discussion above has highlighted some of the main questions that need to be addressed. It has also highlighted that recognising the tradable assets arising in the schemes (ie allowances and credits) is arguably more straightforward than recognising baselines.

47 An issue that the Boards will need to bear in mind is whether the accounting for the two schemes should be consistent, or at least result in the same profit or

loss and net assets upon the allocation of either emission allowances or baselines.

48 The staff raise this issue because the two schemes are designed to achieve the identical targets, even though they do this through different mechanisms. As discussed in Agenda Paper 9A, the allocation of emission allowances effectively establishes a baseline of emissions for a participant.

Event	Cap and Trade Scheme	Baseline and Credit Scheme
Beginning of regulatory period	Participant allocated emission allowances	Participant allocated baseline
End of regulatory period	Participant must remit to regulator emission allowances equal to emissions during the regulatory period.	Participant receives from (must remit to) the regulator emission credits equal to emissions below (above) the allocated baseline.

49 At the end of the compliance period, a participant in a cap and trade scheme remits emission allowances equal to the level of emissions. In a baseline and credit scheme, a participant receives (remits) a net amount reflecting the difference between its actual emissions and the assigned baseline. Provided that the amount of allocated emission allowances is equal to an assigned baseline, a participant would end up with the identical excess (shortfall) of emission allowances or credits.

50 If the Boards were eventually to conclude that allowances and credits should be recognised (with corresponding gains recognised in profit or loss) but that baselines should not be recognised, then the effect on profit or loss will be different in the two schemes.

51 The mechanisms in the scheme are different, however. Whereas a participant in a cap and trade scheme is granted tradable emission allowances, a participant in a baseline and credit scheme receives a baseline that is, generally, tied to the source of emissions and therefore, cannot be separately transferred. In a cap and trade scheme, a linkage between the source of emissions and the allocation of emission allowances applies only to future instalments. A participant is not entitled to receive emission allowances in future compliance periods if the source of emissions is closed and/or the

production falls below a specified level. Only under certain conditions do the schemes allow for a transfer of future instalments or baselines if a source of emissions has been replaced.

QUESTIONS FOR THE BOARDS DISCUSSION

52 Do the Boards need more information on the schemes?

53 Do the Boards think that the accounting issues at the outset of both schemes should be resolved jointly?