Financial Accounting Standards Board

International Accounting Standards Board

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INFORMATION FOR OBSERVERS

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

INTRODUCTION

1 This Agenda Paper contains an example highlighting the potential accounting effects for a major European power company in the current commitment phase (2008 – 2012). Additionally, this Agenda Paper reflects the discussions the staff have held with constituents about accounting for emissions trading schemes.

2 The Agenda Paper is set out as follows:

a Impact assessment (¶3-¶9);

b Discussions with constituents (¶10-¶19).

IMPACT ASSESSMENT

3 As the following example shows, the accounting for emissions trading schemes may have significant effects on the statement of financial position and the statement of income for some industries. The example is based on publicly available information about a major European utility operating under the EU ETS (ie a cap and trade scheme). The utility sector is considered to be the one most heavily affected by emissions trading schemes.

4 The table below shows the annual instalments of emission allowances (EAs) the entity is entitled to under the 'national allocation plan'. The entity will receive these emission allowances by the end of February each year from 2008 through 2012. The table also shows the entity's annual expected emissions. The amounts are in millions of tonnes (Mt) of CO_2. Each emission allowance may be used to offset one tonne of CO_2. For illustration purposes it is assumed that the entity's financial year ends on the 31st of March.

	emissions forecast p.a. Mt CO_2	allocated EAs p.a. Mt CO_2	fraction of granted EAs	expected shortfall p.a. Mt CO_2
European utility	47	37	79%	10

5 Assuming a constant market price for emission allowances of €23, the fair value of each annual instalment would amount to approximately €850 million. The fair value of the entity's annual remittance obligation would be approximately €1,080 million, resulting in a net annual shortfall of €230 million. (It is understood that these amounts would fluctuate based on changes in the market price of allowances over time. In 2008, the forward price for the most liquid emission allowance future contract (settlement in December 2008) on the European Climate Exchange oscillated between EUR 18.84 and EUR 29.33.)

6 If the Boards come to the conclusion that the allocation of emission allowances should result in a gain upon initial recognition, this European utility would recognize an initial gain of €850 million. In its first financial year affected by the scheme (ie the year ending 31 March 2008), the utility would recognize emissions expenses for only the first three months of the

calendar 2008 compliance year. At a constant price of €23 per emission allowance, the total expense recognized would be €270 million. Hence, the annual income statement of the first financial year affected by the scheme shows a net gain from participating in the scheme of €580 million.

7 In the subsequent financial years, the net impact of participating in the scheme will remain constant, as each financial year will capture one annual emission allowance instalment and emissions expenses covering a 12-month period. In this example, the effect of participating in the scheme is a net annual expense of €230 million. This applies to all subsequent financial years except for the one which ends after the completion of the final compliance year (if the scheme is not renewed). As that reporting period starts after the last instalment, no receipt of allowances is recognised. The income statement of that financial year will show a net expense of €810 million. In this utility's interim reports, however, there will be a net gain recognized from the scheme in each quarter ending on the 31st of March, and there will be net expense recognized in each other quarter.

8 It should be noted that under some schemes, a compliance period and/or the allocation of emission allowances covers a period of more than one year. In those situations, the effect of participating in the scheme will not be relatively consistent from one financial year to the next.

9 In this example, the utility recognizes only those emission allowances that are allocated for the respective compliance year. However, it should be noted that the annual instalments for all compliance years within the commitment period (2008 to 2012) have already been determined. A subsequent change is unlikely given that the allocation mechanism has been codified into law. Hence, if the Boards decide that rights to receive allowances qualify as assets and meet the recognition criteria under the frameworks, the gain on initial recognition in the first year increases correspondingly. The income statements for subsequent years within the commitment period would reflect only the emissions expenses.

DISCUSSIONS WITH CONSTITUENTS

10 The staff has engaged with various constituents. The accounting issues arising under the schemes have been discussed, amongst others, with preparers (eg major European emitters), analysts and standard setters. The views that have been expressed differ.

11 The sample preparers strongly support an approach that does not result in a gain upon allocation of emission allowances. They think it is appropriate to account for granted emission allowances at a nominal amount, i.e. nil. For subsequent measurement, they seem to favour an approach that distinguishes between a trading and non-trading book. This would reflect the fact that major emitters also engage in trading activities.

12 The preparers argue that a gain upon initial recognition does not reflect the economics the entities are exposed to. They note that emissions trading schemes are regulatory policies that impose net costs on their organizations, rather than presenting them with net gains. Generally, the allocated emission allowances do not cover their expected emissions for the compliance year, and therefore entities are required to incur costs to buy additional allowances or install equipment to reduce emissions. The sample preparers are concerned that the recognition of an initial gain may mislead investors and particularly, the public. In times where the financial results of utilities are under public scrutiny, they highlight that this may have political implications.

13 Overall, preparers supported an historical cost model with costs recognized in the income statement consistent with the model for contingent rent in EITF Issue No. 98-9, 'Accounting for Contingent Rent'.

14 The staff wants to emphasize that the sample of preparers is small in numbers and has a geographical focus (Europe, U.S.). Preparers in different jurisdictions may react differently. However, the sample entities are among those most heavily affected by emissions trading schemes in the world.

15 The sample analysts expressed a concern when recognising a gain upon allocation of emission allowances. They agree with preparers that recognizing

a gain upon allocation does not reflect the overall economics of the arrangement. They also indicated that if the Boards were to require recognition of a gain upon allocation, they would reverse that gain out of the income statement when preparing their analyses. Accordingly, they felt that including such a gain would not provide decision-useful information. Further, they cannot see why the profit or loss effect should be different under a cap and trade scheme and a baseline and credit scheme—provided they achieve the same target.

16 One analyst raised the issue of future instalments. In an accounting model that results in a gain upon allocation of emission allowances he could not see a reason why an entity should not recognise future instalments. The only condition attached to the instalments is that an entity continues in operation. He assesses the risk that an entity would cease operating to be remote. In his view, the condition for receiving those future instalments is virtually certain to be met.

17 Analysts also agreed with preparers on their preferred overall income statement presentation, namely, consistent with the contingent rent model in EITF Issue No. 98-9. However, they differed with preparers over the balance sheet presentation. They prefer recognizing allowance assets and scheme obligations based on the fair value of allowances and recognizing the mark-to-market adjustments in other comprehensive income.

18 The staff think that the views expressed by the analysts are representative. However, the staff acknowledge that there may be analysts with different views.

19 The discussions with standard setters have revealed different views. Whereas some standard setters seem to be reluctant to support recognising a gain upon initial recognition of emission allowances, others seem to be more inclined to the idea of a gain arising on the allocation of emission allowances.