



Project	Emissions Trading Schemes
Topic	Accounting for the right to future instalments

Purpose

1. The purpose of this paper is to discuss the accounting for the right to receive allowances in an emissions cap & trade scheme *before* the related allowances have been issued.
2. The papers prepared for the joint November 2009 meeting (Memo 4a, Agenda Paper 3a) on the Emissions Trading Schemes project included a brief discussion on the accounting for the right to receive allowances in future compliance periods. However, the boards did not discuss the issue at that meeting because of time constraints. This paper resumes the discussion on the accounting for the right to receive allowances in future compliance periods and includes some additional aspects not considered in the November papers.
3. This paper is not asking the boards for any decisions. The staff think that a decision on the accounting for the right to receive allowances in future compliance periods requires considering whether any related obligations exist. The boards have yet to make a decision on the accounting for the obligations that arise in emissions trading schemes. Hence, this paper assumes that the right to future instalments does not create a single unit of account with any related obligations (ie a unit that reflects net expected inflow or outflow of allowances as result of the introduction of the scheme). The paper includes questions for the boards (paragraphs 23, 34) that will give staff direction in developing accounting guidance for emissions trading schemes.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

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4. This paper deals with the following:
 - (a) accounting for an entity's right to an allocation of allowances in a voluntary scheme (9 - 23)
 - (b) additional considerations that arise in statutory (ie mandatory) schemes (24 - 34)

Background

5. When an entity becomes a member of a voluntary scheme, it undertakes an obligation to pay one allowance for each unit of emissions that it emits during the commitment period. In exchange, the entity receives the right to an allocation of allowances. The allocation represents a level of *allowable emissions* up to which an entity may emit without incurring costs of emitting. The level of allowable emissions is typically below the level of historic emissions and reflects an entity's emissions target. The allowances issued under an allocation take the form of tradable items. The scheme administrator typically establishes an exchange that facilitates buying and selling allowances.
6. For administrative reasons, the commitment period of an emissions trading scheme is often split into annual compliance periods. That means an entity:
 - (a) receives the allowances under its allocation in yearly instalments at the beginning of each compliance year, and
 - (b) surrenders allowances at the end of each compliance year to offset its emissions in that compliance year.
7. The right to receive allowances under future instalments is typically contingent on an eligible entity continuing its emitting operations. If an entity closes its emitting operations, it is no longer entitled to receive allowances for following years. Different schemes define closure differently. Closure could include temporary or partial closure as well as full closure. An emitting operation could be considered closed when it ceases operation altogether, ie zero production, or when its production or emissions drop below a certain threshold.

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8. The following example will be used throughout the paper to highlight possible impacts of closure rules on the accounting for a right to receive future instalments of allowances in an emissions cap & trade scheme:

On 1 January 2010 Polluter Co becomes a member of a voluntary scheme with a five year commitment period, starting on 1 January 2010. The commitment period is split into five annual compliance periods with the first compliance period starting on 1 January 2010.

Polluter Co is entitled to a total allocation of 500 allowances during the commitment period that is issued in five successive instalments on 1 January in each compliance year (ie 100 allowances per year). Each instalment is contingent on Polluter Co continuing its emitting operations in the preceding year. For example, if Polluter Co ceases its emitting operations in 2010 it is no longer entitled to receive 100 allowances on 1 January 2011 (and thereafter). Upon closure, Polluter Co retains allowances it has already received (ie closure applies prospectively).

For illustration purposes, the impact of two different closure rules will be considered:

- (a) Closure A occurs if Polluter Co stops its emitting operations for a period of more than three months in a compliance period (no quantitative production requirement)
- (b) Closure B occurs if Polluter Co runs its emitting operations at less than 50 per cent of capacity in a compliance period

Accounting for an allocation in a voluntary scheme

9. The accounting issue related to the right to an allocation of allowances is whether, and when, the right to receive future allowances under an existing allocation meets the asset definition in the boards' frameworks. In the example, Polluter Co is entitled to an allocation of 500 allowances during the commitment period, issued in five yearly instalments of 100 allowances. *FASB Concept Statement 6* defines an asset as follows:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
[paragraph 25]

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10. The IASB *Framework* defines an asset as follows:

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. [paragraph 49]

11. As discussed last month, there is little doubt that allowances received meet the asset definition. There is more debate as to whether, and when, a right to future instalments of allowances creates an asset if closure of an entity's emitting operations entitles the scheme administrator to disallow existing allocations.
12. There are two different views on whether, and when, a right to future instalments of allowances in a voluntary scheme meets the asset definitions in the boards' frameworks. The views conclude differently on whether, and when, an entity *controls* a resource:
- (a) According to View 1, an entity does not control a resource until the contingencies related to the right to receive allowances are resolved.
 - (b) According to View 2, an entity controls a resource when the entity holds a right that will result in the entity receiving allowances if the entity takes specified actions (typically, continuing to emit at a specified level). That right is an option and the entity exercises it by undertaking the specified actions.

View 1

13. View 1 is that Polluter Co does not control a resource until the right to the unissued allowances is no longer contingent on the occurrence of a future event. Before the contingencies are resolved, Polluter Co may expect to receive allowances but does not yet control any resource associated with the related allowances. Polluter Co controls a resource, according to View 1, when only the passage of time is required in order to receive the allowances under an instalment.
14. View 1 acknowledges that the right to future instalments creates an economic resource before the contingencies are resolved. The allowances that result from future instalments have the capacity to result in cash inflows to the entity or

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reduction in cash outflows from the entity. According to View 1, however, Polluter Co does not control the resource associated with future instalments as long as the right to future instalments is conditional on Polluter Co continuing its emitting operations (referred to in this paper as “conditions attaching to the instalments”). There are two alternative views as to whether, and when, Polluter Co controls the resource associated with future instalments:

- (a) View 1a: Polluter Co controls the resource associated with the future instalments when it is probable¹ that Polluter Co will meet the conditions attaching to the instalments; or
- (b) View 1b: Polluter Co controls the resource associated with the future instalments when Polluter Co meets the conditions attaching to the instalment.

15. View 1a requires Polluter Co to determine continuously the probability of it resolving the contingencies associated with future instalments. Polluter Co controls the resource when it is probable that Polluter Co will meet the conditions attaching to the instalments. The staff understand many entities will attach a high probability to meeting the conditions attaching to future instalments. The preparation of financial statements on the assumption that an entity is a going concern, in many cases, implies an entity will meet the conditions attaching to future instalments. Typically, closure (ie not resolving the conditions) occurs only if an entity liquidates or curtails materially the scale of its operations. Hence, View 1a may result in many entities controlling the resource associated with instalments long before the commencement of the related compliance periods. That means Polluter Co may control a resource related to the receipt of 500 allowances as early as 1 January 2010 (initiation of membership) if it is probable that Polluter Co resolves the contingencies attaching to the allocation. (We do not discuss in this paper how Polluter Co would recognise that resource, if recognised.)

¹ Control could also be determined by reference to an alternative criterion (eg more likely than not, highly probable, virtually certain).

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16. According to View 1b, Polluter Co controls the resource associated with the future instalments only when Polluter Co meets the conditions attaching to the instalments. Hence, Polluter Co controls a resource later if View 1b applies than if View 1a applies. However, View 1b also results in entities controlling a resource before the commencement of the related compliance period. Consider the two different closure rules in the example:
 - (a) Polluter Co stops its emitting operations for a period of more than three months in a compliance period (Closure A)
 - (b) Polluter Co runs its emitting operations at less than 50 per cent of capacity in a compliance period (Closure B)
17. According to View 1b, Polluter Co resolves the conditions attaching to the instalment for the 2011 compliance year not later than 30 September 2010 if Closure A applies. This is because after 30 September there is no possibility that Polluter Co stops its emitting operations for a period of more than three months in the 2010 compliance period. That means on 30 September 2010 Polluter Co controls a resource related to 100 allowances for the 2011 compliance year (but it does not yet control a resource related to the allowances for the compliance periods 2012 – 2014).
18. If Closure B applies, Polluter Co resolves the conditions attaching to the instalments depending on the capacity level at which Polluter Co runs its emitting operations in the 2010 compliance period. Polluter Co resolves the contingencies related to the 2011 instalment not later than 30 June 2010 if it runs its emitting operations at 100 per cent of its capacity in 2010. This is because Polluter Co runs its operations at least at 50 per cent of its capacity in 2010 even if Polluter Co stops operating after 30 June 2010. That means on 30 June 2010 Polluter Co controls a resource related to 100 allowances for the 2011 compliance year (but it does not yet control a resource related to the allowances for the compliance periods 2012 – 2014).

Excursus

19. In some schemes, administrators issue allowances for a compliance period and participants have to return allowances if they close in that compliance period (ie closure applies retrospectively). Applying View 1 to such a scheme means that an entity does not control access to the resource related to allowances received until the conditions are resolved (despite the entity having the right to sell the allowances). This is because the retention of the benefits from the allowances is conditional on the entity not closing its emitting activities in that compliance period. Hence, one view is that allowances received do not create assets controlled by the entity as long as the entity has not resolved the conditions. An alternative view would be to present the allowances as assets and a related liability, reflecting the obligation to return allowances if closure occurs. The latter view reflects the fact that entities are free to sell allowances despite any return obligations and that the entity may repurchase any allowances from the market if it has to satisfy a return obligation.

View 2

20. View 2 concludes differently from View 1 as to *when* a right to future instalments of allowances meets the asset definitions in the boards' frameworks. According to View 2, Polluter Co controls a resource before the conditions attaching to future instalments of allowances are resolved. The resource is the **option** to obtain allowances under future instalments. Polluter Co controls access to that option (because it can restrict others' access to that resource). Polluter Co has the power to obtain the future economic benefits from that option by exercising it if Polluter Co concludes that exercise is beneficial. The option results from a past event (allocation decision) and the right to that option exists at the financial statement date.
21. Applying View 2 means that none of the closure rules affect the conclusion that Polluter Co's right to future instalments creates an asset before the conditions are resolved. The right to an allocation (including all of the instalments) is an asset that comes into existence on 1 January 2010 when Polluter Co becomes a member of the scheme. That asset is the option to receive 500 allowances

during the five year commitment period. Polluter Co exercises that option by continuing to satisfy the necessary conditions (for example by not breaching Closure rule A or Closure rule B in the examples). The conditions affect both the intrinsic value and the time value of the option.

Question for the boards

22. The boards have addressed in other joint projects the accounting for the right to access resources in future periods. In the Discussion Paper *Leases*, for example, the boards concluded that options to extend the lease term meet the asset definition and tentatively decided to recognise options as part of the right-of-use asset. On the other hand, in the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*, the boards tentatively decided that the rights and obligations in a contract with a customer are not presented as separate assets and liabilities but give rise to a single asset or liability.²
23. The staff think that the accounting for the right to future instalments, to some extent, is linked to the accounting for the obligations that arise in an emissions trading scheme. That means a decision on the accounting for the right to future instalments requires considering whether any related obligations exist. Hence, staff are not asking the boards to make any decisions related to the accounting for future instalments at this meeting. The question for the boards will give staff direction in developing an accounting model for emissions trading schemes.

Question for the boards

Do you have any comments on the staff analysis of the right to future instalments in a voluntary scheme? Which parts of the analysis do you disagree with and why?

² Staff point out that the approach in the discussion paper on revenue recognition is based on the assumption that a contract with a customer conveys rights to an entity to receive consideration from the customer and imposes obligations on the entity to transfer assets to the customer. In the Emissions Trading Schemes project, the boards have not yet decided whether the right to receive allowances under future instalments imposes obligations on the entity to transfer assets.

Additional considerations in statutory schemes

24. The staff note that statutory (ie mandatory) emissions cap & trade schemes add an additional dimension to the question of whether, and when, the right to future instalments of allowances meets the definition of an asset in the boards' frameworks. This is because statutory schemes are established by governments (or governmental bodies) and do not result from an arm's length transaction between knowledgeable, willing parties. Statutory schemes are not created on the basis of binding contracts between unrelated parties. Hence, a participant in a statutory scheme is in a different position to a participant in a voluntary scheme. A participant in a voluntary scheme can typically enforce its rights by going to court if the scheme administrator does not discharge its responsibilities or the participant can decide to exit the scheme prior to maturity of the scheme.
25. Participants in a statutory scheme, arguably, have less ability to enforce their rights. That means statutory schemes may provide scheme administrators with greater discretion to subsequently amend features of a scheme. Hence, uncertainty surrounding allocations in a statutory scheme is greater compared than in a voluntary scheme. This is because it is not only closure that affects an entity's right to an allocation of allowances. An entity's right to an allocation may also be affected by interventions of the scheme administrator that are outside the entity's control. The extent to which the scheme administrator has discretion to change an entity's right to an allocation depends on various factors. One factor might be whether entities are legally entitled to prevent allocation changes without their consent. In addition, allocation plans may include caveats as to the allocation decisions (in addition to closure rules). Enforceability of a right to an allocation will also depend on a jurisdiction's legal system. Entities may, or may not, have the ability to enforce statutory rights by a court, for example in accordance with the legal principle known in the United States as promissory estoppel. Constituents emphasize the importance of a reliable allocation decision in order to provide a firm basis for investment decisions. For that reason, some statutory schemes accept and even communicate that the allocation decisions are enforceable. However, staff are not aware

enforceability has been challenged so far in any of the major schemes so that any conclusions seem premature.

26. In the European Union Greenhouse Gas Emissions Trading Scheme (EU ETS), for example, allocation plans seem not to provide discretion to change allocations. The national allocation plans have been endorsed by EU authorities so that scheme participants can enforce their rights to an allocation by application to a court should a scheme administrator aim to change the allocations. The staff understand one reason for endorsement is to strengthen investor confidence by providing a reliable basis for investment decisions into the regulated industries. As a result, market participants in EU ETS view existing allocations as virtually certain, as evidenced in business combinations where acquirers pay premiums because of rights to allocations.
27. There are different views on whether a government's discretion to subsequently change existing allocations affects an entity's control over a right to receive future instalments of allowances:
- (a) According to View 1, an entity does not control a resource until the scheme administrator can no longer change an existing allocation. Arguably, this is not before the allowances have been issued.
 - (b) According to View 2, an entity controls a resource irrespective of whether the scheme administrator can change an existing allocation. The entity controls the right to its future instalments because it can restrict others' access to that resource. The uncertainty surrounding the allocation decision does not affect an entity controls access to that a resource but is a measurement issue.

View 1

28. View 1 takes the view that a scheme administrator's discretion to change an allocation means an entity does not control a resource until the scheme administrator no longer has the ability to change the allocation. The fact that the allocation does not result from a binding contract between knowledgeable, willing parties calls into question enforceability of the arrangement.

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Governments may have the ability to unilaterally change allocations without consequences. According to View 1, the uncertainty surrounding the allocation decision means that an entity does not control a resource as long as there is a possibility of the government changing the allocations.

View 2

29. View 2 concludes differently. View 2 takes the view that an entity controls a resource irrespective of whether the scheme administrator can change an existing allocation. The resource is the de facto option to obtain allowances under future instalments should they occur. An entity controls access to the right to its future instalments (because it can restrict others' access to that resource). The uncertainty surrounding the allocation decision does not affect an entity's control of the resource. According to View 2, it is only the level of the resource that is uncertain (ie amount of allowances to be received from the resource).
30. Some, although agreeing that an entity controls a resource related to its future instalments, view the right to future instalments as a form of internally generated intangible. This is because an entity's right to future instalments does not result from a contract but is the outcome of an entity's past activities. For example, an entity may have been running a power plant for a number of years which entitles the entity to control access to its future instalments. U.S. GAAP does not permit recognising internally generated intangibles outside business combinations. IFRSs, in restricted circumstances, permit recognising internally generated intangibles outside business combinations. However, the right to future instalments, arguably, does not meet the criteria for recognition as an internally generated intangible asset according to IAS 38 *Intangible Assets* (eg entity cannot usually measure reliably the expenditure attributable to the intangible asset during its development).³

³ This view implies that an entity recognises the right to future instalments separately from goodwill in a business combination. Staff understand that the accounting for the right to future instalments, currently, is a controversial issue in business combinations.

31. The issue of a government having discretion to subsequently change access to a restricted resource (ie allocation) is not unique to emissions trading schemes. Governments, for example, grant access to restricted resources by, for example, transferring or allocating airport landing rights, licenses to operate radio or television stations, import licenses or quotas. In all of those examples, access to the restricted resource is conditional on the government not revoking or changing its allocation decision. In addition, the allocation of licenses or quota is typically conditional on the recipient carrying out specified activities. For example, airport landing rights are often conditional on the airline continuing to make use of the landing rights. This is not different to an entity's right to future instalments in an emissions trading scheme that is conditional on an entity continuing its emitting operations.
32. View 2 raises an additional issue: whether an entity controls a resource related to an allocation before the scheme administrator approves the allocation decisions. Specifically, does an expectation to receive an allocation create a resource that an entity controls prior to approval of the allocation? One view is that an expectation to receive an allocation does not create a resource controlled by an entity prior to approval of the allocation. It is the approval of the allocation that creates a resource that an entity controls (similar to a contract).
33. Another view is that approval of an allocation is an arbitrary point to determine *when* an entity controls a resource. By virtue of its activities, an entity controls access to a resource if the entity has a right to be a candidate in the allocation decision and other entities do not have that right. In a statutory scheme, it is typically investment in the regulated industry that entitles to an allocation. Hence, according to this view, an entity controls access to a resource before the allocation decision and it is only the level of the final allocation that is uncertain.⁴

⁴ This paper does not address whether the right to future instalments if it meets the asset definition forms part of the related emitting source or whether it is a separate asset.

Question for the boards

34.

Question for the boards

Do you have any comments on the staff analysis of the additional considerations in a statutory scheme?