Staff Paper

Project: **Emissions Trading Schemes**

Topic: **Balance sheet presentation of the assets and liabilities in an emission trading scheme**

Purpose

1. The purpose of this paper is to analyze whether the allowances (the assets) and related liabilities[1] are eligible for a form of net presentation (ie offsetting[2]). Furthermore, if the allowances and liabilities are eligible for a form of net presentation, should net presentation be required, rather than permitted, when an entity intends to use the allowances to settle the related liabilities?

2. This paper does not address other presentation matters, including the presentation of emissions trading schemes effects within the income statement. Other presentation and disclosure issues will be discussed at a future meeting.

3. The analysis in this paper is applicable to both voluntary and statutory cap and trade schemes.

Prior Board decisions

4. At the September 2010 joint board meeting, the FASB and the IASB tentatively decided that:

[1] Related liabilities refers to the liability for the allocation and the liability for emissions in excess of the initial allocation of allowances.

[2] Offsetting refers to net presentation (as opposed to gross presentation) of an asset and a liability. For example, if an entity offsets its $100 asset with its $120 liability its balance sheet will reflect a $20 liability.

(a) purchased and allocated allowances should be recognised as assets, and

(b) a liability exists when the allowances are allocated (the liability for the allocation), because the definition of a liability is met.

5. At the October 2010 joint board meeting, the FASB and the IASB tentatively decided that allocated allowances should be initially and subsequently measured at fair value. Furthermore, the boards tentatively decided that the liability for the allocation[3] would be measured consistently with the allocated allowances. In addition, the boards expressed support for an approach that determines the quantity of allowances to be returned on the basis of an entity's expectations of emissions or emission reductions.

Summary of staff recommendations

6. Some staff support requiring an entity to present the allowances and related liabilities on a net basis, using a form of linked presentation, when an entity intends to use the allowances to settle the liabilities (View 3). Other staff believe that presenting the allowances and related liabilities on a net basis should be prohibited (View 1). Those staff recommend that gross presentation of the allowances and liabilities is most appropriate.

Background

7. The following table summarizes and compares the guidance on offsetting in IFRS (IAS 32, *Financial Instruments – Presentation*) and US GAAP (ASC Subtopic 210-20, *Balance Sheet-Presentation*)[4]:

	IAS 32 (paragraph 42)	ASC Topic 210-20
	'A financial asset and a financial	'It is a general principle of accounting that

[3] The liability for the allocation is discussed in IASB Agenda Paper XX/FASB Agenda Paper 8A.
[4] The guidance in IAS 32 and ASC Topic 210-20-45-1 was reorganised for the purposes of the comparison.

	liability shall be offset…when, and only when, an entity’:	the offsetting of assets and liabilities in the balance sheet is improper except if a right of setoff exists’[5]. ‘A right of setoff exists when all of the following conditions are met[6]:’
(a)	currently has a legally enforceable right to set off (see (c) below) the recognised amounts	The reporting party has the right to set off the amount owed with the amount owed by the other party and the right of setoff is enforceable at law.
(b)	intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously	The reporting party intends to set off.
(c)	The right of set off can exist in a multilateral arrangement[7].	Each of two parties owes the other determinable amounts.

8. The staff have included this comparison as a starting point for determining whether allowances and liabilities may be eligible for net presentation (offsetting).

Staff analysis

Net presentation of the allowances (the assets) with the related liabilities

9. The staff have proposed three views about whether the allowances and the related liabilities are eligible for net presentation as follows:

    (a) *View 1* – Presenting the allowances with the related liabilities on a net basis should be prohibited.

[5] ASC Topic 210-20-05-1

[6] ASC Topic 210-20-45-1.

[7] Paragraph 45, IAS 32.

(b) *View 2* – Offsetting of allowances with the related liabilities should be permitted when the entity intends to offset because the current guidance is met in principle.

(c) *View 3* – Allowances and the related liabilities should be presented on a net basis, using a form of linked presentation, when the entity intends to offset.

View 1 – Presenting the allowances with the related liabilities on a net basis should be prohibited

10. According to View 1, allowances and the related liability should not be presented on a net basis because the allowances and related liabilities do not meet the criteria in IAS 32[8] or ASC Subtopic 210-20. Although there are two parties in the transaction, the scheme administrator does not owe anything to the entity because the scheme administrator has already transferred the allowances (ie the 'allocation of allowances'). In addition, there is no legally enforceable right to setoff the allowances and related liabilities.

11. Furthermore, View 1 would not permit or require the allowances and liabilities to be presented using a linked presentation, as proposed for the performance obligation model for lessors (View 3 below). This is because there are many other items that have similar (or stronger) relationships, that don't meet the offsetting criteria and yet are still not presented using a linked presentation. One example may be 'in-substance defeasance'[9] where assets are set aside to settle the liability. These items do not meet the offsetting criteria, nor can they be shown using a linked presentation.

12. Thus as noted above, in View 1, a net or linked presentation would not be appropriate and therefore, the allowances (assets) and the related liabilities would be presented gross on the balance sheet.

[8] IAS 1 *Presentation of Financial Statements,* paragraph 32 indicates 'An entity shall not offset assets and liabilities…unless required or permitted by an IFRS'.

[9] Paragraph AG59 of IAS 39 *Financial Instruments: Recognition and Measurement* 'payment to a third party, including a trust…does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release'. This topic is addressed in a similar fashion in ASC paragraphs 405-20-05-2 and 405-20-40-1.

View 2 – The allowances and the related liabilities could be presented net because the criteria for offsetting is met in principle

13. View 1 explains that the allowances and the related liabilities do not meet the specific criteria for offsetting in IAS 32 and ASC Subtopic 210-20[10]. However, under View 2 the criteria for offsetting in IAS 32 and ASC Subtopic 210-20 are met in principle and therefore an entity could present the allowances and liabilities net.

14. One of the key aspects of an emissions trading scheme is that the allowances are the only method that can be used to satisfy the liabilities in the scheme. While this strong relationship does not indicate the existence of a legally enforceable right of offset, it does suggest that the principle behind criterion (a) outlined in the table after paragraph 7 is met, because the liability cannot be settled with another item. Thus, this view assumes that the entity's right to offset always exists, since allocated allowances are designed to settle scheme liabilities.

15. This fact pattern of using the allowances to pay a scheme liability appears analogous to a fact pattern used in guidance contained in US GAAP[11]. This guidance also permits net presentation as follows:

> *Offsetting Securities Against Taxes Payable*
>
> 45-6 The offset of cash or other assets against the tax liability or other amounts owing to governmental bodies shall not be acceptable except in the circumstances described in the following paragraph.
>
> 45-7 Most securities issued by governments are not by their terms designed specifically for the payment of taxes and, accordingly, shall not be deducted from taxes payable on the balance sheet. The only exception to this general principle occurs when it is clear that a purchase of securities (acceptable for the payment of taxes) is in substance an advance payment of taxes that will be payable in the relatively near future, so that in the special circumstances the purchase is tantamount to the prepayment of taxes. This occurs at times, for example, as an accommodation to a local government and in some instances when

[10] See also the table above.

[11] These paragraphs are codified in US GAAP paragraph 210-20-45-6 and 45-7(Balance Sheet – Offsetting), formerly residing in APB Opinion No. 10, *Ominbus Opinion – 1966*, paragraph 7.

governments issue securities that are specifically designated as being acceptable for the payment of taxes of those governments.

16. The relationship between the allowances and the liabilities will also enable some entities to assert that they intend to hold allowances throughout the compliance period for the purpose of remitting them to settle scheme liabilities at the end of the period. In other words, an entity will have an 'intent' to use allowances to settle those liabilities. When an entity 'intends' to use allowances to settle the liabilities, the main principle behind criterion (b) appears to be met.

17. In situations where an entity does not intend to settle on a net basis, for example, if an entity intends to trade its allowances, this would suggest that criterion (b) (outlined in the table after paragraph 7) would not be met. In View 2, these allowances would not be eligible for net presentation with the related liabilities. In this case, net presentation would not faithfully represent an entity's economic position in the scheme, if the entity does not intend to use the allowances solely to settle the liabilities.

18. Although the specific criteria of IAS 32 and ASC Subtopic 210-20 are not met, the interrelated nature of the assets and the liabilities, when combined with an intention to offset (that is, an entity intends to satisfy the liability by delivering allowances), indicates that the criteria are met in principle and thus net presentation (ie offsetting) on the balance sheet is appropriate.

19. Under View 2, the staff would recommend that the notes to the financial statements would include disclosure of the gross amounts of the assets and related liabilities that are presented net on the balance sheet. If this view is selected, this issue will be discussed at a future meeting in the context of other disclosures.

View 3 – Allowances and the related liabilities should be presented on a net basis, using a form of linked presentation

20. According to View 3, the allowances and related liabilities should be presented gross on the face of the balance sheet, but should total to a net emissions asset or net emissions liability (ie a form of linked presentation). This presentation

should be permitted because of the interrelated nature of the allowances and the related liabilities. In particular, because the liabilities can only be settled with allowances. Furthermore, presenting the allowances and liabilities in this way faithfully represents the 'exchange' that will take place between the entity and the scheme administrator at the settlement date.

21. View 3 would however only permit a linked presentation when the entity intends to offset. As described in paragraph 15 above, when an entity does not intend to offset the allowances with the related liabilities (eg if the allowances are to be traded), a linked presentation would not be appropriate.

22. View 3 is consistent with the presentation of the performance obligation approach for lessors in the August 2010 exposure draft *Leases* (paragraph 42). The basis for conclusions explains that the linked presentation:

> 'reflects the interdependency of the underlying asset, right to receive lease payments and the liability, while acknowledging that the criteria for offsetting that would permit the right to receive lease payments and the lease liability to be presented net are not met.' (paragraph BC 148)

Pros and Cons

23. Supporters of View 2 and View 3 highlight that the value of the allowances is only realized upon the settlement of the liability, and thus illustrating an entity's net position best reflects this value realization. In addition, they believe the net presentation more appropriately reflects the amount of expected future cash flows.

24. Proponents of View 2 and View 3 also believe that the interrelationship between the assets and liabilities in an emissions trading scheme is unlike the interrelationship between many other assets and liabilities and thus a form of net presentation is warranted.

25. Proponents of View 2 and View 3 do not believe that gross presentation on the face of the balance sheet provides additional information to the user. Furthermore, we would not expect the emission liabilities that are covered by

allowances to impact an entity's financial ratios such as debt-to-equity, current ratio, etc.

26. Proponents of View 2 and View 3 believe that users can obtain information about the assets that are set aside to cover emission liabilities through the net or linked presentations. Furthermore, the net or linked presentations provide the user with the entity's net long or short position in allowances, which the staff believes is the most relevant information about emission trading schemes.

27. A linked presentation provides more information on the face of the balance sheet than View 2, and prominently displays the effect of an emissions trading scheme on an entity. Supporters of View 3 believe that providing this information on the face of the statement is more useful than providing it in the notes to the financial statements, as in View 2. In addition, they believe a linked presentation is more useful than a gross presentation, as in View 1.

28. Proponents of View 1 argue that allowances do not meet the criteria for offsetting, and so they should not be offset[12]. In particular, there are many examples of assets and liabilities that may be closer to meeting the offsetting criteria, yet the boards have determined that they may not be offset.

29. Proponents of View 1 also do not support a net presentation because they are concerned that an entity could trade the allowances at any time, and reveal a liability that was not previously transparent. Therefore, even though an entity may 'intend' to offset, it can change its intention at any time and sell the allowances (instead of holding for settlement).

30. Proponents of View 1 also do not believe that linked presentation is appropriate. This is because they observe that many other items may be viewed as 'linked' but are not presented net on the balance sheet. One example is items that are hedged. In addition, proponents of View 1 believe that the same information can be presented with equal prominence in the notes to the financial statements.

[12] IAS 1 *Presentation of Financial Statements,* paragraph 32 indicates 'An entity shall not offset assets and liabilities…unless required or permitted by an IFRS'.

Staff recommendation

31. Some staff recommend that presenting the allowances with the related liabilities using a form of linked presentation when an entity intends to use the allowances to settle the liabilities (View 3) is most appropriate. The linked presentation would reflect the interdependency of the allowances and the related liabilities and an entity's intention to offset those assets and liabilities. In addition, this linked presentation is more useful than a gross presentation or a net presentation with disclosure in the notes.

32. Other staff believe that presenting the allowances and related liabilities on a net basis should be prohibited (View 1). These staff recommend that gross presentation of the allowances and liabilities is most appropriate since the offsetting criteria in IAS 32 and ASC Subtopic 210-20 are not met. Furthermore, linked presentation does not appear appropriate, given that other items with stronger relationships are not presented in this manner.

Permitting offsetting versus requiring offsetting

33. If the boards adopt View 2 or View 3, the staff recommend that when the entity intends to use the allowances to settle liabilities in the emissions trading scheme, the entity should be required, rather than permitted, to present the allowances using a linked presentation approach. The staff believe that this will improve comparability between entities.

Question 1 and 2 for the boards:

Q1: Some staff recommend that the allowances (assets) and related liabilities be presented using a linked presentation (View 3). Other staff recommend that the allowances (assets) and related liabilities be presented on a gross basis (View 1). Which view do the boards prefer and why?

Q2: If the boards adopt View 2 or View 3, do the boards agree that a net presentation of the assets and the related liabilities should be required, rather than permitted, if an entity intends to use the allowances to settle liabilities under the emissions trading scheme?