Staff Paper

Project	**Emissions Trading Schemes**
Topic	**Interaction of emissions with the liability for the allocation and recognition and measurement of a liability for excess emissions**

Introduction

1. The purpose of this paper is to discuss how an entity's actual emissions interact with the liability for the allocation and the recognition and measurement of a *liability for excess emissions*. This paper is structured as follows:
   a. Part A - analysis of the interaction of an entity's actual emissions (equal to or below the level of the allocation) with the liability for the allocation[1] .
   b. Part B - analyses when an entity emits in excess of the liability for the allocation and thus must recognise (and measure) a liability for excess emissions.

2. The analysis in this paper applies to both voluntary and statutory cap and trade schemes.

3. This paper does not discuss the presentation issue of netting the allowances against the liabilities in cap and trade schemes. This paper also does not discuss whether (or when) a right to receive future allocations should be recognised as an asset.

[1] At the September 2010 joint meeting the boards tentatively decided that a liability for the allocation exists and should be recognised. The measurement of this liability is discussed in IASB Agenda Paper 5A/FASB Agenda Paper 7A.

Staff recommendations

4. The staff recommend the following:
    a. When an entity emits, it should not recognise a new emission liability. The entity's emissions equal to or below the level of the allocation will affect the measurement of the liability for the allocation, by affecting the expected number of allowances to be returned.
    b. An entity should recognise a liability for excess emissions when the entity's actual emissions exceed the liability for the allocation. This liability for excess emissions will be measured initially and subsequently at the fair value of the allowances that must be provided to the scheme administrator.

Board decisions

5. The boards have not previously discussed this issue.

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

Staff Analysis

7. When an entity produces one unit of emissions, the emission trading scheme rules require the entity to provide the scheme administrator with one allowance[2].

8. When an entity has recognised a liability for the allocation, emissions equal to or below the level of the allocation indicate that an entity must return allowances for that quantity of emissions. (IASB Agenda Paper 5A/FASB Agenda Paper 7A describes the liability for the allocation as an obligation to return the allowances if

[2] This allowance is normally provided to the scheme administrator at the end of a compliance period, but timing isn't relevant for this part of the discussion.

it does not reduce emissions below the level of allocated allowances). Importantly, emissions equal to or below the level of the allocation do not result in a liability *in addition* to the liability for the allocation. When an entity's emissions exceed the level of the allocation, an entity will recognise a liability for excess emissions (Part B).

Part A - Interaction of an entity's actual emissions (equal to or below the level of the allocation) with the liability for the allocation

9. There are two views on how an entity's actual emissions (equal to or below the level of the allocation) interact with the liability for the allocation:

    a. **View 1 –** When an entity emits, it should not recognise a new or different emission liability from the liability already recognized for the allocation. The entity's emissions equal to or below the level of the allocation would affect the measurement of the liability for the allocation, by affecting the expected number of allowances to be returned.

    b. **View 2 –** When an entity emits, an entity should recognise a new or different emission liability from the liability already recognized for the allocation and, at the same time, derecognise a portion of the liability for the allocation.

10. In both views, the entity will not recognise an *additional emission liability* unless the entity emits in excess of the liability for the allocation (Part B).

View 1 *– An entity should not recognise a new or different emission liability - emissions equal to or below the level of the allocation would affect the measurement of the liability for the allocation*

11. When an entity emits equal to or below the level of the allocation, it should not recognise a new or different emission liability because the nature of the liability

has not changed[3]. Rather the measurement of the entity's liability for the allocation would be affected because when the entity emits equal to or below the allocation, it becomes certain that the entity must return allowances related to those emissions. Essentially, the entity has not been able to reduce its emissions below the level of allocated allowances. Emitting equal to or below the level of the allocation would therefore either confirm the entity's assessment of the expected (ie probability-weighted) quantity of allowances to be returned, or adjust that assessment. Given that the liability for the allocation is measured on the basis of the quantity of allowances that an entity expects to return (see IASB Agenda Paper 5A/FASB Agenda Paper 7A), any changes in the quantity of allowances an entity expects to return would affect the measurement of the liability for the allocation.

12. Changes in an entity's estimates related to the liability for the allocation would be reflected in the earnings (profit and loss).

View 2 – *When an entity emits, an entity should recognise a new or different emission liability and, at the same time, derecognise the liability for the allocation*

13. In View 2, when an entity emits equal to or below the level of the allocation an entity should recognise a new or different emission liability because the liability has changed from an estimated liability to a liability without estimates. When an entity has actually emitted, it can no longer reduce its emissions for that quantity of allowances and therefore must return those allowances. Thus, when an entity recognises a new or different emission liability, the entity would derecognise a portion of the liability for the allocation. Effectively as an entity emits, this approach would replace the liability for the allocation with a new or different emission liability.

14. The derecognition of the liability for the allocation would result in the recognition of income. Conversely the recognition of the new or different emission liability

[3] IASB Agenda Paper 5A/FASB Agenda Paper 7A describes the liability for the allocation as an obligation to return the allowances if it does not reduce emissions below the level of allocated allowances.

would result in an expense. These items may be shown separately or together on the statement of income. Presentation issues will be discussed at a future board meeting.

Pros and Cons

15. There should be no difference in the total emission liabilities recognised under View 1 or View 2. For this reason, some may be indifferent as to which view is adopted. Furthermore, disclosure of an entity's actual emissions and total emission-related liabilities is relevant information to users. These disclosures could be required under either View 1 or View 2. Disclosures will be discussed at a future board meeting.

16. Proponents of View 1 believe that emitting does not change the nature of the liability and thus it is more appropriate to adjust an entity's expectations in measuring the liability for the allocation, than to derecognise it and recognise a new or different emission liability.

17. Supporters of View 2 believe that recognising a new or different emission liability and derecognising the liability for the allocation appropriately reflects the change from an estimated obligation to an obligation without estimates. In particular, the obligation is *only* a return obligation, because after the entity emits, it is no longer able to achieve a reduction in emissions for that quantity of allowances (which is possible under the liability for the allocation). Supporters of View 2 believe that this approach may provide more direct information (ie by separately disclosing the new or different liability and the related expense) about the costs of an entity's actual emissions (this information would be included in the disclosure of the changes in the estimates and uncertainties surrounding the liability for the allocation in View 1). Opponents of View 2 support View 1.

Staff recommendation

18. Some staff recommend that the boards adopt View 1 as they believe it is more appropriate to adjust an entity's expectations in measuring the liability for the allocation, than to derecognise the liability for the allocation and recognise a new or different emission liability. Other staff recommend View 2 as they believe that

recognising a new or different emission liability and derecognising the liability for the allocation appropriately reflects the change from an estimated obligation to an obligation without estimates. It also provides more direct information about the costs of an entity's actual emissions.

Question 1
Q1: Which view do the boards support and why?

Part B - When an entity emits in excess of the liability for the allocation

19. When an entity produces emissions in excess of the liability for the allocation, the entity incurs an obligation to obtain[4] additional allowances and provide them to the scheme administrator to offset its excess emissions[5] (ie a liability for excess emissions). The entity must recognise this liability for excess emissions when its emissions exceed the liability for the allocation because this is when the definition of a liability in the boards' Frameworks is met[6] (ie the obligating event is the additional emission).

20. The liability for excess emissions would be initially and subsequently measured at the fair value of the additional allowances that must be provided to the scheme administrator[7]. This is consistent with the staff recommendation to initially and subsequently measure the allowances and the liability for the allocation at fair value (IASB Agenda Paper 5A/FASB Agenda Paper 7A).

[4] These additional allowances will generally be obtained by way of purchase in the market.
[5] Current schemes permit entities to fulfil the obligations for emissions by providing allowances.
[6] The staff concluded that this liability clearly meets the definition of a liability and the related recognition criteria. The staff have therefore not included this analysis in this paper.
[7] In IASB Agenda Paper 5A/FASB Agenda Paper 7A, the staff have recommended that allowances are initially and subsequently measured at fair value. If the allowances are measured using one of the other measurement models described in that paper, there will be measurement differences between these two elements and thus earnings volatility may result. Importantly, volatility in earnings may also result if an entity recognises liability for excess emissions, but does not hold excess allowances.

21. Furthermore, this measurement is consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* FASB's Concepts Statement No. 6 *Elements of Financial Statements* and ASC Topic 420 *Exit or Disposal Cost Obligations*.

22. In addition, the entity would recognise an expense when the quantity of its emissions exceed its allocation.

23. For entities that have not received an allocation of allowances, upon emitting, they would immediately recognise a liability to provide allowances to the scheme administrator (which is the same as the liability for excess emissions).

Pros and Cons

24. This is the only approach that is supported by the boards' Frameworks.

25. The recognition of the liability for excess emissions when emissions exceed the liability for the allocation is expected to affect earnings (profit and loss) later in the entity's reporting period. Some argue that this impact is undesirable for many preparers, and might not provide relevant information for users. They believe this approach will not shed adequate light on large emitters who may have annual emissions that may well exceed the allocated allowances[8]. The staff believe the disclosures described in paragraph 15 may provide this information.

Rejected alternative for when to recognise the additional emission liability

26. Some have proposed that an entity should recognise a liability for excess emissions *before* the entity's actual emissions exceed the liability for the allocation on the basis of estimates of an entity's total emission liability over the entire compliance period. Supporters of this proposal believe that this approach will provide more timely and relevant information for users, since it will better spread the annual cost of emissions over the annual period.

27. The staff rejected this proposal because no obligating event occurs until the entity receives an allocation of allowances or emits. Therefore, this proposal appears inconsistent with the definition of a liability in the boards' Frameworks.

[8] The staff believe that disclosures, including an entity's actual emissions, uncertainties regarding the liability for the allocation and changes in any estimates for the liability for the allocation, will provide the relevant information regarding large emitters. Disclosures will be discussed at a future board meeting.

Staff recommendation

28. The staff recommend that a liability for excess emissions be recognised when an entity's actual emissions exceed the liability for the allocation. The initial and subsequent measurement of the liability for excess emissions will be the fair value of the allowances that must be provided to the scheme administrator.

Question 2
Q2: Do the boards agree with the staff recommendation? If not, why not?