IASB/FASB Meeting September 2010

IASB Agenda reference **10C**

FASB Agenda reference **6C**

Staff Paper

Project	**Emissions Trading Schemes**
Topic	**Issues to be discussed at future board meetings**

Purpose

1. IASB Agenda paper 10/FASB Agenda paper 6 indicated that there are a number of important issues relating to the emissions trading scheme project that will be addressed at future board meetings. This paper describes those issues. Importantly, this paper is only for information purposes and will not be discussed at the joint meeting.

2. The staff do not believe that the recommendation to address these issues at future meetings should preclude the boards` from reaching tentative decisions in AP 10A/6A and AP 10B/6B. It is staff`s view that the boards` discussion and tentative decisions on the recognition of assets and liabilities for the allocation, will help frame and shape the future discussions of the issues outlined in this paper. Furthermore, the staff also believe that the issues and alternatives discussed in this paper may change as a result of those discussions and decisions.

Main issues to be discussed at future meetings

3. The following is a list of the main issues relating to the project (both cap and trade and baseline and credit schemes) that the staff intend discussing with the Boards at future meetings:
   (a) Measurement;

(b) Netting[1] ;

(c) Emitting;

(d) Right to receive future allocations of allowances; and

(e) Baseline and credit schemes.

(a) Measurement: How should the allowances and the liability for the allocation be measured initially and subsequently*?*

Allowances (assets)

4. In AP 10A/6A, the staff recommend that purchased and allocated allowances are assets that should be recognised. The subsequent question is how the allowances should be initially and subsequently measured? The following are possible measurement approaches:

(a) *Model 1 – Fair value with remeasurement*[2]: this model would require purchased and allocated allowances be measured at fair value[3] initially and subsequently at each reporting date.

(b) *Model 2 – Fair value with no remeasurement*: this model would require purchased and allocated allowances to be initially measured at fair value with no subsequent remeasurement for price changes in the active market for allowances at each reporting date. This model would require impairment testing under existing standards (IAS 36 *Impairment of Assets* and Topic 350-30-35 *Goodwill and Other, subsequent measurement*).

(c) *Model 3 – Price paid with no remeasurement*: this model would require the initial measurement of purchased and allocated allowances to be based upon the price paid by the entity at the time of acquisition[4]. Because

[1] We have used this term to distinguish this concept from the mechanics of emissions trading schemes. This concept is the same as described as offsetting in paragraph 42 of IAS 32 *Financial Instruments: Presentation* and Topic 210-20 *Offsetting*.

[2] Remeasurement refers to the change in fair value due to the price change in the assets experienced in the active market.

[3] The fair value of each allowance would be determined using the measurement principles in ASC Topic 820 *Fair Value* and the IASB May 2009 Exposure Draft *Fair Value Measurement*. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

[4] In determining the price paid, the staff will also address the issue of transaction costs.

allocated allowances are received for no monetary consideration, this would result in an initial measurement of NIL for the allocated allowances. For purchased allowances, this model would likely result in the same *initial* measurement as the fair value models. This model would require impairment testing under existing standards.

(d) *Model 4 – Business approach:* this model would require an entity to determine how it intends to use purchased and allocated allowances in order to establish the initial and subsequent measurement attributes as follows:

   i. *Held for use* – allowances determined to be held for use will be used to settle liabilities under the scheme (that is, not sold) and will be initially measured in accordance with **Model 3** (ie NIL for allocated allowances).

   ii. *Trading* – allowances determined to be held for trading will be measured in accordance with **Models 1 or 2**.

5. The boards discussed the initial measurement of the allowances in March and April 2009. The IASB tentatively decided the allowances would be measured at fair value. The FASB did not make any decisions.

Liability for the allocation

6. In AP 10B/6B, the staff recommend that a liability for the allocation of allowances exists and should be recognized. A follow-on question is: How should the liability for the allocation of allowances be initially and subsequently measured?

7. As indicated in AP 10B/6B, although the staff believe that a liability should be recognised when the allowances are allocated, the staff disagree on what the present obligation is. Some staff prefer the view that the present obligation is an obligation to refrain from emitting to keep the allowances (View 1(a) in AP 10B/6B), other staff prefer the view that the present obligation is an obligation to comply with the scheme requirements; to refrain from emitting to keep the

allowances or to return the allowances if the entity emits (View 1(c) in AP 10B/6B).

8. The different views on the nature of the present obligation will influence the discussion on the measurement of the liability for the allocation. This is because resources required to settle each obligation will be different. However the staff believe that the measurement of the liability, regardless of the nature of the obligation, will be based (in some way) upon the number of the allocated allowances that may be returned.

9. The allowances are like a currency that can be used to settle liabilities related to the scheme. For this reason, the staff believe that the liability for the allocation of allowance will be measured on the same basis as the allowance itself.

10. One approach will thus be to use the price of the allowances used in the initial measurement of the asset (allowances) to measure the liability at that date for the allocation of the allowances.

11. The staff believe that it is important to measure the liability subsequently on the same basis as is used to measure the allowances subsequently, to help avoid a mismatch of gains and losses in the income statement.

12. The boards have not yet discussed the measurement of the liability for the allocation.

(b) Netting: Should entities present the purchased and allocated allowances and the related liabilities on a net basis?

13. When an entity is required to return allowances to the scheme administrator, the only way it can settle this liability is by delivering the allowances. The allowances (in the case of a cap and trade scheme) function similarly to a currency. Given this interaction between the allowances and the related liabilities, the staff are considering the following alternatives:

    i) *Permitting netting of allocated allowances based on intent*: if an entity receives an allocation of allowances and intends to use those allowances to settle the liability for the allocation, the entity would be permitted to net the allocated allowances with the related liability.

ii) *Permitting netting of purchased allowances based on intent*: if an entity purchases allowances with the intent to hold the allowances to settle those liabilities incurred beyond the liability for the allocated allowances (see below for further explanation), the entity would be permitted to net the purchased allowances with the incurred liability.

iii) *Requiring netting based on intent*: if an entity intends to use either allocated or purchased allowances to settle emissions liabilities, the entity would be required to net, and present net assets and liabilities within the scheme.

iv) *No netting*: stand-alone guidance would not be developed. Furthermore, because the current standards for netting are not met, the netting of assets and liabilities within an emissions trading scheme should be prohibited.

14. The boards have not discussed the issue of netting assets and liabilities in emissions trading schemes.

(c) Emitting: how does it interact with the liability for the allocation?

15. In AP 10B/6B, the staff recommend that a liability for the allocation of allowances be recognised. How is the liability for the allocation affected when an entity emits? Staff are currently considering 2 alternatives:

i) If an entity's emissions do not exceed the allocated allowances, the entity's production of one unit of emissions does not result in a liability *in addition* to the liability for the allocation. Rather, emitting will determine the way in which the liability for the allocation is settled: by returning allowances. Therefore, the event of emitting may affect the measurement of the liability for the allocation as outlined above.

UUUU<u>An entity will recognise a liability for emitting only when an entity's emissions exceed the allocation of allowances.</u>

ii) When an entity emits, a different liability is created because the liability for the allocation changes to a liability to return allowances. <u>An entity will therefore recognise a liability to return allowances for every unit of emissions and, at the same time, derecognise a portion of the liability for the allocation.</u>

16. A further issue is the measurement of this liability. However, the staff do not believe that it will be difficult for the Boards to determine how to measure this liability.

17. The boards have not yet discussed this issue.

(d) Right to receive future allocations of allowances

18. A participant in an emissions trading scheme may receive an allocation of allowances from the scheme administrator. For administrative reasons, the scheme administrator may determine the total number of allowances to allocate to an entity for a defined commitment period. Typically, this commitment period is made up of a number of compliance periods, which are usually annual periods. Although the total number of allowances over an entire commitment period may be known at the beginning of the period, the allowances are only physically transferred to the entity for one compliance period at a time (usually at the beginning of the compliance period). Therefore, throughout the commitment period, the entity will have a *right to receive* future allocations of allowances.

19. An entity`s right to receive future allocations may be contingent upon the entity continuing its operations above a specified level (ie not ceasing operations[5]). Furthermore, in a statutory scheme, the scheme administrator may or may not

[5] As discussed in AP 10B/6B, if an entity ceases operations it may also be required to return the current years` allocation of allowances.

have the power to amend the amount of the future allocations at any time during the commitment period by[6].

20. The relevant question is whether (and when) a right to receive future allocations should be recognised as an asset. The staff believe that the analysis of this question will also include an analysis of the obligations related to this asset, including whether and when a liability should be recognised. The staff are developing alternatives for this issue. The alternatives will incorporate the tentative decisions resulting from AP 10A/6A and 10B/6B.

21. The IASB discussed this issue in December 2009. The issue was presented for information purposes only and no technical decisions were made.

(e) Baseline and credit

22. Baseline and credit schemes have similar objectives to cap and trade schemes; under both schemes, specific emissions are targeted for reduction through the use of a market (trading) mechanism. The structure of a baseline and credit scheme is however different from that of a cap and trade scheme.

23. In a baseline and credit scheme, the government allocates the ‘cap’ in the form of baselines. Instead of creating transferable allowances up to the overall cap and then allocating allowances to eligible participants, baseline and credit schemes assign baselines of emissions to regulated sources of emissions.

24. As baselines are linked to specific sources of emissions, participants cannot buy or sell baselines separately nor can they be traded immediately on ‘allocation’.

25. Under a baseline scheme, credits are created at the end of the compliance period, after emissions have been verified. A source that has emitted below its baseline receives credits equal to the difference. On the other hand, a source that has emitted in excess of its baseline is required to surrender credits equal to the

[6] There may be limitations in the scheme administrators` ability to amend the terms of the future allocations. However it is a relevant fact that should be considered.

difference. As the baseline is a sum of units of emissions, it can thus be viewed as a sum of emission credits.

26. Credits issued are transferable and may be sold or banked for use in future compliance periods (provided the scheme allows for the carry-forward of credits to other compliance periods).

27. The main accounting issues in a baseline and credit scheme are the same as the initial questions in a cap and trade scheme: what are the assets and liabilities (if any) in baseline and credit schemes?

28. The staff are currently considering 2 alternatives. To recognise:

    a) both an asset and a liability – for the allocated baseline and a present obligation **(View 1)** or

    b) an asset **–** for the right to receive credits **(View 2**)

29. The boards discussed baseline and credit schemes in an educational session in October 2008. No decisions were made.