# STAFF PAPER

**29–30 January 2014**

## IFRS Interpretations Committee Meeting

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| **Project** | **IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*** | | |
| Paper topic | Measurement of liabilities under IAS 37 within the context of emission trading schemes | | |
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## Introduction

1. In September 2013, the IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify the measurement of a liability arising from participation in an emission trading scheme under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

2. The objective of this Agenda Paper is to provide the Interpretations Committee with a summary of the issue and with the staff's research and analysis. This Agenda Paper also contains two questions for the Interpretations Committee. We propose that the Interpretations Committee should not add this issue to its agenda. Hence, this Agenda Paper includes proposed wording for the tentative agenda decision.

3. This Agenda Paper is structured as follows:

   (a) summary of the issue;

   (b) divergent practice identified by the submitter;

   (c) discussions in the Emission Trading Schemes project of the IASB;

   (d) assessment against the agenda criteria of the Interpretations Committee;

   (e) staff recommendation;

(f) questions for the Interpretations Committee;

(g) Appendix A—proposed wording for tentative agenda decision;

(h) Appendix B—assessment against the Interpretations Committee's agenda criteria; and

(i) Appendix C—submission.

## Summary of the issue

4. Emission trading schemes are designed to achieve a reduction of greenhouse gases through the use of tradable emission permits. The form of scheme could vary from jurisdiction to jurisdiction; however, we understand that two main types of schemes have been a 'cap and trade scheme' and a 'baseline and credit scheme'.

5. IFRIC 3 *Emission Rights*, which was withdrawn in June 2005, addressed the accounting for rights and obligations arising from the participation in a cap and trade scheme. An entity subject to the scheme is required to deliver emission allowances equal to its actual emissions that have been made up to the end of a compliance period. The allowances held by the entity comprise those issued by the scheme administrator for free and those purchased from other participants.

6. We understand that the jurisdiction of the submitter has, or will have, a similar regime in which an entity is required to deliver emission allowances equal to its actual emissions made for a period. Hence, the submitter asks for clarification of the measurement under IAS 37 of the obligation to deliver allowances.

7. The submitter refers to paragraph 8 of IFRIC 3, which stated that the obligation to deliver allowances for past emissions should be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The paragraph further stated that the best estimate will usually be the present market price of the number of allowances required to cover emissions made up to the balance sheet date.

8. Paragraph BC24 of IFRIC 3 stated that this view arose from the requirements in paragraph 36 of IAS 37. That paragraph requires a provision to be measured at "the best estimate of the expenditure required to settle the present obligation at the

balance sheet date". It further states that 'the best estimate' is described as the amount that an entity would rationally pay to settle the obligation or to transfer it to a third party.

9. The submitter also notes that in IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*, the Interpretations Committee provides its interpretation of the requirements for measurement of liabilities within the scope of IAS 37. Paragraph BC3 of IFRIC 1 states that IAS 37 requires provisions to be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. Thus, the amount of provisions should be adjusted for a change in estimated outflows of resources embodying economic benefits and/or the discount rate.

10. Accordingly, the submitter is of the view that the measurement of the liability for the obligation to deliver allowances should reflect the current values of allowances at the end of each reporting period if IAS 37 was applied to the measurement of the liability.

11. On the basis of that view, the submitter is seeking confirmation from the Interpretations Committee on its views taken in those Interpretations.

## Divergent practice identified by the submitter

12. The submitter identified published evidence of divergent practice around the world for the measurement of an obligation to deliver allowances under emission trading schemes. In particular, the submitter is aware of two views:

    (a) a mixed measurement approach, in which the liability is measured on the basis of the carrying amount of allowances held by the entity. If the allowances held by the entity are insufficient, the balance of the liability is measured on the basis of the present market price of allowances; and

    (b) a current value measurement approach, in which the liability is measured independently of the carrying amount of the allowances held by the entity by the reference to the present market price of the number of allowances required to cover emissions made (ie the submitter's view).

13. The submitter states that this issue is of a general and fundamental nature. Thus, this issue is also relevant to the measurement of liabilities under IAS 37 in other types of transactions.

## Discussions in the Emission Trading Schemes project

14. The Interpretations Committee decided in 2002 that it should develop an interpretation of IFRS for the accounting for a cap and trade scheme. This was because of concerns raised by interested parties for the accounting for the European Emission Trading Scheme, which started in January 2005. As a result of the project, IFRIC 3 was issued in December 2004. IFRIC 3 specified that:

    (a) allowances are intangible assets in IAS 38;

    (b) the issue of allowances free of charge by government is a government grant; accordingly, the allowances are initially recognised as an intangible asset at fair value and the corresponding entry is a deferred income;

    (c) a liability is recognised for the obligation to deliver allowances equal to emissions made as emissions are made. This liability is measured at the end of each reporting period by the reference to the current market value of the allowances;

    (d) the entity amortises the government grant (deferred income) to profit or loss; and

    (e) allowances are derecognised on their sale (if sold in the market) or on their delivery to the government in settlement of the entity's obligation to deliver allowances to cover emissions. If the allowances are traded in an active market, they are not amortised.

15. In June 2005, the IASB decided to withdraw IFRIC 3. In the statement in relation to the withdrawal, the IASB stated that:

(a) It is questionable whether there is as urgent a need for an Interpretation as originally concluded by the Interpretations Committee in 2004.

(b) IFRIC 3 is an appropriate interpretation of existing IFRS for accounting for the European Emission Trading Scheme.

(c) However, as a consequence of following existing IFRS, IFRIC 3 creates unsatisfactory measurement and reporting mismatches.

16. The IASB acknowledged that the interaction between IAS 38 and IAS 37 created:

(a) a measurement mismatch between the assets and liabilities recognised in accordance with IFRIC 3. This arises because the revaluation of intangible assets under IAS 38 is an option (paragraph 72 of IAS 38), while IAS 37 requires a provision to be adjusted for the current best estimate (paragraph 59 of IAS 37);

(b) a mismatch in the location in which the gains and losses on those assets and liabilities are reported. This mismatch arises because the revaluation of intangible assets is recognised through other comprehensive income (paragraphs 85 and 86 of IAS 38), while the adjustment of a provision is recognised through profit or loss (illustrative example in IFRIC 3); and

(c) a timing mismatch. This mismatch arises because allowances are recognised when they are obtained, which is typically at the start of the year (paragraph 18 of IAS 38), while a liability is recognised over the year as it is incurred (paragraph 14 of IAS 37).

17. In September 2005, the IASB added the Emission Trading Schemes project to its agenda (and activated the project in December 2007). When the IASB added this project to its agenda, it noted that considerable diversity in practice has arisen since IFRIC 3 was withdrawn. The IASB also noted that the issue is of international relevance, with many jurisdictions implementing or discussing emissions trading schemes. The IASB has received requests from several national standard-setters to address the issue.

18. The project considered, in particular, how allowances received from the scheme administrator should be recognised and measured, and what liabilities, if any, relating to the receipt of allowances should be recognised and measured. In the discussions, the IASB confirmed that the project should not be constrained by existing IFRS, but the *Conceptual Framework* would still be relevant.

19. However, in November 2010, discussions on the Emission Trading Schemes project were deferred. The project was still in the early stages of development. The IASB have made tentative decisions on some of the main issues in the project. For example, in October 2010, the IASB tentatively decided that the measurement of the allocated allowances and the liability for the allocation should be consistent. However, there are many issues in the project that are yet to be discussed.

20. In May 2012, the IASB added the Emission Trading Schemes project as a research project following the agenda consultation in 2011.

## Assessment against the agenda criteria

21. In this section, we assess the issue against the agenda criteria of the Interpretations Committee as described in paragraphs 5.14–5.21 of the *Due Process Handbook*. Please refer to **Appendix B** to this Agenda Paper for the details of the agenda criteria and the assessment of the issue against the agenda criteria.

22. We note that the IASB and the Interpretations Committee were already aware in the previous projects that this issue is significantly widespread. In addition, it was confirmed that there has been significant diversity in practice on the accounting for emission trading schemes. This is primarily because authoritative guidance in this area has not existed since the withdrawal of IFRIC 3.

23. We note, however, that the IASB intended to consider the accounting for both assets and liabilities arising from emission trading schemes as a package. The IASB also thought that it should develop an accounting model free of constraints of the requirements in existing IFRS. The IASB noted that applying the requirements in existing IFRS as interpreted in IFRIC 3 would result in unsatisfactory accounting and reporting mismatches.

24. The concerns about the mismatches were raised primarily because there is a legal linkage between the rights held and obligations incurred by the entity in emission trading schemes. In emission trading schemes, the obligation to deliver allowances can be settled only by the allowances held by the entity. The obligation to deliver allowances is defined in terms of the units of allowances.

25. The IASB stated that IFRIC 3 was an appropriate interpretation of existing IFRS for accounting for the emission trading scheme in Europe. However, it decided to withdraw IFRIC 3 and started a new project in order to address accounting implications of the unique linkage between the asset and liability.

26. Accordingly, given the withdrawal of IFRIC 3, we think that the issue related to the measurement of a liability arising from an obligation to deliver allowances is too broad for the Interpretations Committee to deal with. We think that this issue should not be viewed as only a measurement issue of liabilities under IAS 37, but linked also to the accounting for the allowances. In this regard, we think that this issue would not be comparable to the measurement of liabilities under IAS 37 in other transactions.

27. We also note that in May 2012, the IASB decided to add the Emission Trading Schemes project to its agenda as a research project. We think that the measurement of a liability arising from an obligation to deliver allowances would be better addressed in the IASB's project.

28. On the basis of the analysis above, we are of the view that this issue does not meet the agenda criteria of the Interpretations Committee.

## Staff recommendation

29. We recommend to the Interpretations Committee that it should not add this issue to its agenda. This is because this issue is too broad for the Interpretations Committee and should therefore be addressed in a more comprehensive project of the IASB.

## Questions for the Interpretations Committee

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| 1. Does the Interpretations Committee agree with the staff recommendation that the Interpretations Committee should not add this issue to its agenda? |
| 2. If the answer to Question 1 is 'yes', does the Interpretations Committee agree with the wording of the tentative agenda decision in **Appendix A** to this Agenda Paper? |

## Appendix A—Proposed wording for the tentative agenda decision

**IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*—Measurement of liabilities arising from emission trading schemes**

The Interpretations Committee received a request to clarify the measurement of a liability under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* that arises from an obligation to deliver allowances in an emission trading scheme.

The request asked if the measurement of the liability for the obligation to deliver allowances should reflect current values of allowances at the end of each reporting period if IAS 37 was applied to the liability. The request noted that this was the basis required by IFRIC 3 *Emission Rights*, which was withdrawn in June 2005.

The Interpretations Committee noted that IFRIC 3 addressed the accounting for both the emission allowances and the obligation to deliver allowances as a result of emissions made, but that this was withdrawn by the IASB. It noted that the primary reason for the withdrawal was that the interpretations of existing IFRS set out in IFRIC 3 resulted in unsatisfactory accounting and reporting mismatches between assets and liabilities arising from an emission trading scheme. The Interpretations Committee noted that the IASB's project on emission trading schemes was aimed at addressing the accounting for the assets and liabilities as a package. Consequently, the Interpretations Committee observed that the issue of the measurement of the liability for the obligation to deliver emissions allowances is broader than just the interpretation of the measurement requirements in IAS 37 but that it also relates to the accounting for the associated allowances.

On the basis of the analysis above, the Interpretations Committee observed that this issue is too broad for the Interpretations Committee to deal with, and consequently [decided] not to add this issue to its agenda.

## Appendix B—Assessment against the Interpretations Committee's agenda criteria

B1. In the table below, we have assessed the issue against the agenda criteria of the Interpretations Committee as described in paragraphs 5.14–5.22 of the *Due Process Handbook*.

| **Agenda criteria of the Interpretations Committee** | |
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| We should address issues (see paragraph 5.16): | |
| that have widespread effect and have, or are expected to have, a material effect on those affected; | **Met**<br>It was confirmed in the Emission Trading Schemes project of the IASB that this issue is of international relevance. |
| where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and | **Met**<br>It was confirmed in the Emission Trading Schemes project of the IASB that there has been significant diversity in practice on the accounting for emission trading schemes. This is primarily because authoritative guidance in this area has not existed since the withdrawal of IFRIC 3. |

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| that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*. | **Not met**<br>The primary reason for the withdrawal of IFRIC 3 was that the interpretations of existing IFRS as set out in IFRIC 3 resulted in unsatisfactory accounting and reporting mismatches between assets and liabilities arising from an emission trading scheme. Hence, an accounting model developed for emission trading schemes may not be consistent with the requirements in existing IFRS. In the Emission Trading Schemes project, the IASB intended to develop an accounting model free of constraints of the requirements in existing IFRS.<br>Thus this issue cannot be resolved efficiently within the confines of existing IFRS. |
| In addition: | |
| Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs (see paragraph 5.17)? | **Not met**<br>Because following existing requirements in IFRS could result in unsatisfactory accounting and reporting mismatches, this issue should be considered from the perspectives of both the asset side and the liability side. Furthermore, a resulting accounting model may not be derived from the existing requirements in IFRS.<br>Thus, this issue is too broad for the Interpretations Committee to deal with in an efficient manner. |

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| Will the solution developed by the Interpretations Committee be effective for a reasonable time period (see paragraph 5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified). | **Not met**<br>The Interpretations Committee already developed an interpretation of existing IFRS for this issue in 2004, but the IASB withdrew it in 2005 to consider this issue more comprehensively. Thus, a short-term solution by the Interpretations Committee is no longer justified. |

## Appendix C—Submission

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Australian Accounting Standards Board

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6 September 2013

Mr Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon
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UNITED
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Dear Wayne

**Clarification of measurement of liabilities under IAS 37 in the context of ETSs**

We are writing to seek clarification of the IFRS Interpretation Committee's position on an aspect of measuring liabilities under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. We note that the issue has previously been discussed in IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* and (the now withdrawn) IFRIC 3 *Emission Rights*.

IFRIC 1, paragraph BC3, notes that IAS 37 requires provisions to be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. Thus in regard to changes in liabilities addressed by IFRIC 1, when the effect of a change in estimated outflows of resources embodying economic benefits and/or the discount rate is material, that change should be recognised based on a current value measurement of those liabilities involving the application of a current market-based discount rate.

IFRIC 3, paragraph BC24, reflected the then IFRIC's view that the obligation to deliver allowances for past emissions would normally be measured at the present market price of the number of allowances required to cover emissions made at the balance sheet date and noted that this view arose from paragraph 36 of IAS 37, which requires a provision to be measured at the 'best estimate of the expenditure required to settle the present obligation at the balance sheet date'.

Based on the above, our understanding is that the amount required to settle an obligation at the balance sheet date should reflect current values, being the amount that an entity would rationally pay to settle the obligation or transfer it to a third party.

However, there is some published evidence of divergent practice around the world in recognising and measuring emission liabilities[1]. Some of that evidence suggests variable application of IAS 37. In particular, a mixed measurement approach has been adopted by some entities for measuring emission liabilities in which the value of the emission obligation is based on the carrying value of allowances already granted (which may be recognised at a nil value) and the purchase price of other allowances. Where the allowances granted or purchased are insufficient, the balance of the liability is measured at the prevailing market price of allowances. Other entities have adopted a current value measurement basis for the entire emission liability. Incidentally, paragraph BC25 of IFRIC 3 guarded against such a treatment by noting that the cost of allowances (or their initial fair value, if issued for less than fair value) was not the amount that the participant would rationally pay to settle its obligation, rather, the amount required to settle an obligation at the balance sheet date would reflect current values. IFRIC 3 also noted that liabilities are measured independently of how those liabilities would be funded.

Although the evidence referred to above relates to the divergent practices developed in regard to measuring liabilities in the context of ETSs, we believe the issue is relevant to how to account for liabilities under IAS 37 more broadly. We think the issue may also have raised concerns in other jurisdictions internationally that would need to apply IAS 37 in recognising and measuring liabilities, whether in the context of ETSs or otherwise.

We are aware that the IFRS Interpretations Committee has transferred the issue of accounting for ETSs to the IASB, which has a planned research project to deal with it in a comprehensive way. This letter is written with a view to seeking confirmation from the Committee on the previous positions taken in various IFRICs in regard to measurement of liabilities under IAS 37. The confirmation sought is of a general and fundamental nature and is in the context of existing IFRS. It should not be seen only as an ETS-specific issue although it could be beneficial to jurisdictions that have such schemes in operation or planned.

The clarification would also provide a context for those who are developing approaches for accounting for ETSs for possible consideration by the IASB (eg. the French standard setter ANC, EFRAG) and those developing approaches under existing IFRSs (i.e before any IASB developments on the topic of ETS).

[1] See for example, Accounting for Carbon, The Association of Chartered Certified Accountants (UK), 2010 and Trouble-Entry Accounting – Revisited, Uncertainty in accounting for the EU Emissions Trading Scheme and Certified Emission Reductions, PricewaterhouseCoopers (PwC) and International Emissions Trading Association (IETA), 2007.

We have written before about Australian carbon tax in relation to IFRIC 21 *Levies* but we may also face the prospect of an ETS. This letter is written in relation to the latter as a separate matter.

If you require further information on the matters raised above, please contact me or Ahmad Hamidi (ahamidi@aasb.gov.au).

Yours sincerely

Kevin M. Stevenson
Chairman and CEO