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STAFF PAPER

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Project	Pollutant Pricing Mechanisms		
Paper topic	Project update and responses to the Agenda Consultation		
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Purpose of this paper

1. This paper provides a summary of :
   (a) the Pollutant Pricing Mechanisms (PPM) research project's current status and planned next steps; and
   (b) the feedback received from the Agenda Consultation on the project.
2. The Board is not asked to make decisions about the project at this meeting. It will be asked at a future meeting to provide views on the balance and content of its overall work plan, and the prioritisation of projects, including the PPM project, within the work plan.
3. This paper sets out:
   (a) the project scope and objectives (paragraphs 4-5),
   (b) a summary of the project status and public discussions since the start of the project (paragraphs 6-9),
   (c) an overview of the issues identified to date (paragraphs 10-24),
   (d) a summary of feedback received about the project in the 2015 Agenda Consultation (paragraphs 25-31), and
   (e) planned next steps (paragraphs 33-34).

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Objective and scope of the Pollutant Pricing Mechanisms research project

4. The objectives of the project are:

   (a) to identify the financial effects of a variety of common pollutant pricing mechanisms (PPM) that put a price on the volume of greenhouse gases or other pollutants emitted (or captured);

   (b) to identify how those PPM are currently being accounted for in IFRS financial statements by participants in the schemes; that is by entities that emit or capture the specified pollutants and are subject to the terms and conditions of authorised PPM; and

   (c) to consider whether the Board could improve the quality of the reporting of PPM by undertaking a Standards-level project to amend or supplement existing IFRS Standards.

5. The Board decided an initial project plan in January 2015. It agreed that the scope of the research undertaken to identify different types of PPM should be wide-ranging. This is to help identify the range of possible accounting issues that may be relevant in deciding whether there are gaps or inconsistencies in existing IFRS Standards that the Board should consider addressing. The Board also decided to develop a Discussion Paper as the first due process output for the project.

Current project status

6. The project is currently classified as an assessment stage project within the research programme. Our research so far has identified that there is diversity in how PPM are accounted for. We have identified that some of the issues relate to possible gaps in IFRS Standards and others to possible inconsistencies in existing IFRS Standards. Some issues are interrelated with issues that are being considered in other projects on the Board's current work plan. We are still establishing the significance of the problem. We will work with staff on the other projects, especially the *Conceptual Framework* project and the research project on Provisions, Contingent Liabilities and Contingent Assets, as we assess whether a

viable solution (or solutions) could be developed in a cost-efficient and timely manner.

Public discussions

7. So far, we have received input on issues and possible accounting solutions through the following meetings with the IASB and its advisory groups:
   (a) IASB meetings in November 2014 (education session), January 2015, June 2015 and October 2015 (education session);
   (b) Accounting Standards Advisory Forum (ASAF) meetings in December 2014, July 2015 and October 2015;
   (c) Global Preparers Forum (GPF) meeting in November 2014; and
   (d) Joint Capital Markets Advisory Committee (CMAC) and GPF meeting in June 2015.
8. The meetings in 2014 provided staff with initial views about the main areas of concern to help scope the project. A major concern expressed, particularly by preparers of IFRS financial statements, was a wish not to reach the same conclusions as previously reached in IFRIC 3 *Emission Rights*. This Interpretation was issued in December 2004 and focussed on the accounting for a cap-and-trade type of emissions trading scheme (ETS). The Interpretation was withdrawn in June 2005 because of perceived problems with the creation of 'accounting mismatches' that many stakeholders stated would not fairly present the economic effects of the scheme.
9. So far, the technical discussions with the Board and its advisory bodies have focussed on the cap-and-trade type of ETS but, as a result of those discussions, staff have more recently been looking at the financial effects of other types of schemes that have been identified through the research conducted. This is helping to identify and clarify which aspects of the accounting for PPM are already covered by existing IFRS Standards and where there are possible gaps and inconsistencies.

Overview of the issues identified

10. So far, the staff have identified several issues that we consider worthwhile including in the planned Discussion Paper. Some of the issues are not expected to require the development of specific accounting requirements; for example, some indirect carbon taxes operate in a similar way to common types of sales taxes or value added taxes. However, it may be helpful to note this in education type material within the Discussion Paper. Some of the issues have yet to be discussed with the Board because our research on the issues is still in its early stages.

11. In some jurisdictions, governments use more than one type of PPM to achieve their emission reduction objectives. We have been able to group them into four main categories:

    (a) ETS, including both cap-and trade, and baseline-and-credit types—these schemes use tradeable emissions allowances to incentivise participants to reduce emissions. Participants that emit below a specified level are able to sell surplus emissions allowance while other participants that emit above a specified level need to acquire additional emissions allowances to cover their excess emissions;

    (b) Clean Development Mechanism (CDM) and similar incentive schemes—these schemes incentivise participants to reduce the level of emissions, either by providing participants with types of emissions allowances that can be sold or be used to offset obligations to remit emissions allowances under ETS or by providing cash or other financial incentives;

    (c) Carbon-capture type schemes—these schemes incentive participants to capture pollutants, commonly through forestry and land management activities. Participants are rewarded through either financial incentives or by receiving types of emissions allowances that can be sold or be used to offset obligations to remit emissions allowances under ETS; and

    (d) Carbon taxes or levies—these schemes impose either a direct tax or levy on pollutants emitted or an indirect tax on the manufacture or sale of specified products, such as petroleum or electricity.

12. As noted in paragraph 6, some issues are closely interrelated with issues being considered in other projects. The outcomes of those other projects may provide sufficient guidance to eliminate the need to develop specific accounting requirements for PPM. In other cases, the issues may be more specifically related to PPM but this does not automatically mean that specific accounting requirements will be needed. The following paragraphs highlight the main issues identified so far.

Interaction with IFRIC Interpretation 21 Levies

13. A carbon tax that applies directly to the volume of pollutants emitted has similar economic effects to an ETS, particularly a baseline-and-credit ETS, when the participant expects to emit more pollutants than the baseline. IFRIC 21 would generally apply to the carbon tax, which means that, if the tax applies only above a threshold, a liability is not recognised until the threshold is passed. However, IFRIC 21 has a scope exemption for ETS. In practice, we have seen that, if ETS participants expect to emit a quantity of pollutants above the baseline or number of allowances on hand, those ETS participants commonly recognise a liability for the expected cost of the excess emissions before the threshold is passed. The liability is built up throughout the period based on the actual quantity of emissions to date compared to the total expected volume of emissions for the period.

14. Consequently, although the economic effects are similar, the pattern of expense recognition may differ significantly—for the carbon tax, no expense is recognised until the threshold is exceeded but the ETS expense is recognised throughout the period. We currently do not think that the difference in the economics of the mechanisms supports the inconsistency in accounting.

Interaction with the Conceptual Framework—definition of a liability

15. In many cap-and-trade ETS, participants receive an allocation of emissions allowances free-of-charge from the government. In these cases, the participants treat this as the receipt of a non-monetary government grant and account for the receipt in accordance with IAS 20 *Accounting for Government Grants and*

Disclosure of Government Assistance. However, paragraph 23 of IAS 20 permits an accounting policy choice: participants can:

(a) recognise both an asset (the emissions allowances) and a deferred income balance initially at the fair value of the emissions allowances received;[1] or

(b) recognise both the asset and the grant at a nominal amount—which in the case of an allocation of allowances free-of-charge is nil. This has the same effect as not recognising the emissions allowances in the statement of financial position.

16. Some stakeholders have questioned whether the 'deferred income' balance arising from the application of the accounting policy outlined in paragraph 14(a) meets the definition of a liability in the *Conceptual Framework*. This is because they see any obligation to return the allocated emissions allowances to the government as being contingent upon the future emission of pollutants. However, most stakeholders do not think that recognising a gain when the emissions allowances are received would faithfully represent the financial position and performance of the participant. This is because, in most cases, any such gain is merely temporary—participants generally receive free-of-charge allocations only when they are existing polluters. Unless the participant closes down the production facility that causes the emissions, they would be expected to return many, if not all, of the emissions allowances received.

Other issues

Measurement of the liability to remit emissions allowances to the government based on emissions to date

17. There is diversity in practice about how emissions allowances received free-of-charge are recognised and measured initially in the statement of financial position, because both of the accounting policies outlined in paragraph 15 are used. Similar diversity flows through to the measurement of the obligation to remit emissions allowances to the government to cover the quantity of pollutants emitted during

[1] This treatment is consistent with the consensus in IFRIC 3 (withdrawn).

the period. Our initial research indicates that most participants measure the liability in the following way:

(a) Any obligation that is covered by emissions allowances held is measured at the carrying amount of those emissions allowances.

(b) In cases in which the participant expects to emit a higher volume of pollutants than the quantity of emissions allowances held, a liability for the excess is measured using the reporting date market value of emissions allowances. As noted in paragraph 13, ETS participants commonly build up the liability throughout the period based on the actual quantity of emissions to date compared to the total expected volume of emissions for the period.

18. Consequently, if two participants emit the same quantity of pollutants during the period, the total amount of the liability recognised may differ significantly, depending on the policy adopted for the measurement of the emissions allowances held.

Net presentation

19. The measurement of the liability described in paragraph 17 is a form of 'net presentation, ie the amount of the liability is presented net of the carrying amount of any emissions allowances held at nil. We have also observed the use of a net presentation in the income statement. The cost of acquiring the emissions allowances required to cover the pollutants emitted during the period is generally reduced by the carrying amount of any allocated emissions allowances received free-of-charge, irrespective of whether those allocated allowances are recognised in the statement of financial positon at nil or at their fair value on initial recognition. We have heard mixed views about the usefulness of this approach.

When to recognise gains

20. In both types of ETS, incentive mechanisms and carbon-capture type mechanisms, participants are rewarded for reducing emissions or capturing pollutants below specified levels. The reward may be in the form of emissions allowances, cash or other financial incentives. This raises questions about when to recognise an asset for the receipt of the expected reward and how to categorise the income. If the

reward is in the form of emissions allowances, how should they be measured? So far, these issues have not been discussed with the Board and we have not yet identified what accounting policies are being used in practice.

21. In ETS, participants do not need to hold emissions allowances before emitting the pollutants covered by the mechanism. In all ETS observed so far, the date on which participants are obliged to remit to the government sufficient emissions allowances to cover the pollutants emitted during the period falls after the end of the current compliance period.[2] This allows participants to sell emissions allowances during the period, even if the participant may expect to need to purchase replacement emissions allowances at a later date. Some users of financial statements and other stakeholders have expressed concern that recognising gains on the sale of emissions allowances could be misleading in such cases.

What type of asset is an emissions allowance?

22. Although most stakeholders accept that the emissions allowances are assets, some question how to classify them because emissions allowances seem to have characteristics of different types of assets. They seem to fall into the category of intangible assets because they do not satisfy the strict definitions of financial instruments, inventories and property, plant and equipment. However, many suggest that the accounting requirements of IAS 38 *Intangible Assets* were not designed with such assets in mind and do not fairly present their economic characteristics.

23. In the absence of specific IFRS requirements, we have seen diversity in how the emissions allowances are classified in practice. Although many classify them as intangible assets, others classify them as inventory and apply the requirements of IAS 2 *Inventories*. However, it is not yet clear whether this difference in classification is a driver for diversity in the accounting outcome. As previously described, many ETS participants account for emissions allowances at cost, both initially and subsequently. Consequently, there seems little difference in the accounting treatment.

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[2] The compliance period is the period, typically of one-year duration, over which a participant must verify its emissions to quantify its obligation to remit emissions allowances to the government.

What is the period of account?

24. In many PPM, including ETS, the government sets the requirements for the mechanism over a 'commitment period', which may cover several calendar years. The commitment period is commonly split into several compliance periods, which commonly last one year. Questions have been raised about whether the participants should account for their rights and obligations under the mechanisms looking at each compliance period in isolation or whether the participants' position and performance should be reported relative to the commitment period as a whole.

Feedback from the 2015 Agenda Consultation

Comment letters

25. More than half of the respondents to the 2015 Agenda Consultation referred specifically to the PPM project. [3] Some, mainly Standard-setters and accountancy bodies plus a securities regulator and an investor representative group, ranked PPM as a project of high importance and urgency. The remaining respondents had mixed views about whether the project is of medium or low importance, although more of them ranked it of low urgency.

26. In terms of geographical trends, views are mixed. The strongest support for the project comes from economies in which the use of PPM is either relatively recent or growing, including Korea, Canada and India. The majority of respondents in Europe considered the project to be of medium priority.

27. Respondents who ranked the project as important and/or urgent provided the following reasons for their views:
    (a) PPM are becoming increasingly widespread and are increasing in importance;
    (b) there is no guidance in IFRS Standards; and
    (c) practice is diverse.

[3] 119 comment letters have been received on the 2015 Agenda Consultation.

28. Respondents who ranked the project as of low importance and/or low urgency provided the following reasons for their views:

    (a) in some jurisdictions and industries, PPM is not a major issue and the Board should focus on more pervasive issues that affect a greater number of entities;

    (b) the issues could be dealt with through the *Conceptual Framework* project or through existing IFRS Standards or through disclosures; and

    (c) existing practice adequately depicts performance within PPM.

Online survey

29. To provide input for the development of the Board's future agenda, the staff also conducted an online survey to understand the views of the investor community about the areas of financial reporting that are in the most urgent need of improvement.

30. A little more than two-thirds of the users of financial statements who participated in the survey ranked the PPM project.[4] Of these, half ranked the project as high or medium importance. Conversely, almost two-thirds of other respondents to the survey ranked the project as of low importance.[5] More than a third of the other respondents who ranked the project as low priority are preparers of financial statements.

31. A few users of financial statements made specific comments about the increasing relevance of this emerging issue, both in terms of the number of entities affected and the significance of the amounts involved, given developments around climate change and emissions controls.

[4] 86 users of financial statements participated in the survey, of which 60 responded to the question about the PPM project.

[5] 51 other respondents to the survey addressed the PPM project.

Other information

32. The International Public Sector Accounting Standards Board (IPSASB) is also conducting research in this area because PPM are usually designed and administered by government or by a government-appointed designated body, termed a scheme administrator. The IPSASB aims to publish in mid-2016 a staff Background Paper on Emissions Trading Schemes (ETS) outlining public policy objectives, choice of interventions and their economic impact. The IPSASB also aims to publish a Consultation Paper, which will focus primarily on the accounting by government and scheme administrators but will also consider the accounting by participants, some of whom will be government departments or government enterprises. In March 2016, the IPSASB paused its work on the Consultation Paper, awaiting progress on the Board's PPM project.

Next steps

33. In the coming months, the staff plan to present to the Board a series of papers that will include:
    - (a) a summary comparison of types of PPM, including:
        - (i) ETS (both cap-and-trade and baseline-and-credit types);
        - (ii) Clean Development Mechanism (CDM) and similar incentive schemes;
        - (iii) Carbon-capture type schemes; and
        - (iv) Carbon taxes or levies.
    - (b) an analysis of the economic drivers and financial effects of the different types of PPM;
    - (c) a comparison of possible accounting models for different types of PPM;
    - (d) a summary of principles identified and how they relate to the *Conceptual Framework for Financial Reporting* and requirements in existing Standards;

(e) consideration of whether any proposed model could be achieved through amendments to, or an Interpretation of, existing Standards or whether a new Standard would be needed; and

(f) consideration of the implications of any IPSASB proposals for the accounting by government and scheme administrators, in particular whether symmetry of accounting treatment is relevant.

34. The findings in the research project, and the feedback we receive on the findings, will help the Board to decide whether to start a Standards-level project on PPM in the future.