Emission Trading Schemes

Background and history

1. Emission trading schemes are designed to achieve a reduction of greenhouse gases through the use of tradeable emission permits. They are a relatively recent phenomenon, although the concept of using a tradeable permit as a means of efficiently achieving a social objective has been familiar to economists for some time. Such schemes are an integral part of the Kyoto Protocol, the 1997 international agreement under which most developed countries agreed to legally binding targets that will reduce emissions of the six main greenhouse gases by at least 5% below 1990 levels over the period 2008-2012.

2. The theory behind emissions trading relies on the creation of value through the allocation of a right to emit pollutants. The allocation of the right to emit is distributed differently depending upon the type of scheme. The two main types of schemes are a cap and trade scheme and a baseline and credit scheme.

3. In a cap and trade scheme, a central authority (eg government) sets an overall cap on the amount of emissions that can be released in a specified compliance period. This cap is then allocated to entities by distributing ‘emission allowances’. Each emission allowance provides a right to emit one tonne of CO₂ (or other greenhouse gas). Under most schemes, governments currently issue the majority of allowances to emit free of charge to entities. The cap, and therefore the allowances, will normally be below the actual levels of emissions currently being made by entities, thus creating scarcity. This scarcity creates value for the holders of such rights.

4. Allowances can be traded. Accordingly, an entity that has excess allowances (ie allowances in excess of its actual or anticipated emissions) from reducing its emissions will sell its allowances to another entity that requires allowances because of growth in emissions or an inability to make cost-effective reductions in emissions.

5. In a baseline and credit scheme, the government allocates the ‘cap’ in the form of baselines. The baseline also provides an entity a right to emit up to a specified level. The baselines are assigned to a specific emitting source and can not be traded. The trading mechanism is introduced at the end of the period, when the government issues tradable ‘credits’ to entities that have emitted below their baseline. Conversely, the government requires entities that have emitted above their baseline to provide credits.
6. An example of a cap and trade scheme is the European Emission Trading Scheme (the EU ETS), which started in January 2005. This is the largest company-level, multi-sector cap and trade emissions trading scheme in the world.

7. The proposals for the EU ETS raised questions about the appropriate accounting for the scheme in accordance with IFRSs, in particular about the accounting treatment for allowances issued for less than fair value by government. Because the EU ETS would affect many IFRS preparers in Europe, the IASB’s International Financial Reporting Interpretations Committee (IFRIC) decided in 2002 that it should develop an interpretation to explain how entities should apply IFRSs to cap and trade schemes like the EU ETS.

Draft interpretation (D1)

8. The IFRIC developed proposals for accounting for cap and trade schemes in accordance with IFRSs in 2002-2003, and issued draft interpretation D1 Emission Rights in May 2003.

9. Many respondents to D1 welcomed that the IFRIC had tackled this topic—they thought that guidance in this area was important, although some observed that because emission trading schemes were in their infancy the guidance was premature. However, few respondents agreed with the proposals in D1. In particular, many respondents cited a scenario in which an entity receives allowances at the start of the year equal to anticipated emissions for the year and in which the entity does not trade its allowances, because the allowances will be held to settle the forecast year-end emission obligation. These respondents contended that the accounting in this scenario should have no effect on profit or loss because the entity was emitting within its allowed limit. Thus many expressed the view that a net loss (net gain) should be reported in profit or loss only if the entity produced more (fewer) emissions than the allowances with which it was issued (or if the entity traded its allowances).

10. During its redeliberations, the IFRIC considered but rejected alternative interpretations offered by respondents. It concluded that D1 was the only interpretation of IFRSs (even though it had precluded the use of one of the options in IAS 20). Nonetheless, the IFRIC was troubled by the effects in profit or loss of the mixed measurements of the standards that it was interpreting (ie allowances under IAS 38 at cost, emission obligations at a current value under IAS 37) and mixed reporting (ie changes in the value of allowances measured at fair value in equity, changes in the value of emission obligations in profit or loss).

11. Accordingly, in December 2003, the IFRIC sought the Board’s permission to develop a possible amendment of IAS 38. The objective of the amendment was to create a new subset of intangible assets in IAS 38, including emission allowances, which could be measured at fair value through profit or loss. The IFRIC’s view was that this would alleviate some (but not all) of the effects in profit or loss from the mixed measurement and reporting requirements of IASs 38 and 37. This is because the asset (allowance) and liability (emission obligation) would be measured on a consistent basis with all changes in value reported in the same place, ie profit or loss.

12. The Board agreed that the IFRIC could pursue the development of an amendment of IAS 38. However, the Board also noted that in 2002 it had decided to amend IAS 20 (which the IFRIC had concluded determined the accounting treatment of allowances issued for less than fair value by government). The Board therefore proposed that the IFRIC’s amendment to IAS 38 and its own work on IAS 20 should be linked and issued as a package later in 2004, together with a new draft Interpretation based on the proposed amended Standards.
13. Due to agenda and staff constraints, little progress was made on IAS 20 in 2004. Meanwhile the IFRIC was coming under pressure from constituents about the lack of guidance on accounting for the EU ETS. Therefore, in September 2004, the IFRIC decided to issue its Interpretation (IFRIC 3 Emission Rights) largely as exposed in D1. It also emphasised to its constituents that it was committed to developing an amendment to IAS 38 for the Board’s consideration as soon as possible.

14. IFRIC 3 was issued in December 2004. It specified that

- allowances are an intangible asset.
- 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 credit.\(^1\)
- during the year, as the entity emits CO\(_2\), a liability is recognised for the obligation to deliver allowances at the end of the year to cover those emissions. This liability is measured at the end of each reporting period by reference to the current market value of the allowances.
- during the year, the entity amortises the government grant (deferred credit) to profit or loss.
- allowances are derecognised on their sale (if sold into 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.

Withdrawal of IFRIC 3

15. During 2005, the IFRIC developed its proposed amendment of IAS 38. The staff of the EFRAG also developed a model for accounting for the EU ETS. Not only did it propose measuring the allowances at fair value like the IFRIC, it also proposed that gains and losses on allowances held to meet highly probable emission obligations should be deferred in equity and recognised when those emissions occurred (i.e., a cash flow hedging model). The IFRIC’s work and the EFRAG staff proposal were considered by the Board at its June 2005 meeting.

16. In June 2005, the Board also considered a request from the European Commission to defer the effective date of IFRIC 3 (although it was already effective from 1 March 2005). The EC observed that markets for EU allowances, which are necessary for the proper functioning of the EU ETS, although developing rapidly, were thin. As a result, the Board reasoned that there was not as urgent a need for an Interpretation as originally concluded by the IFRIC in 2004.

17. Accordingly, in the light of the reduced urgency for an Interpretation and the requests from the IFRIC to amend Standards, the Board decided to withdraw IFRIC 3 so that, free of the IFRIC’s constraint of interpreting existing Standards, it could address the underlying accounting in a more comprehensive way than originally envisaged by the IFRIC.

\(^1\) The IFRIC decided to preclude entities from using the option in IAS 20 that would have allowed them to recognise the allowances issued by government at nominal amounts.
Agenda decision and scope

18. At its September 2005 meeting, the Board added the topic of emissions trading to its agenda. In addition, the Board decided that the Emissions Trading Schemes project should be conducted concurrently with the project to revise IAS 20 Accounting for Government Grants and Disclosure of Government Assistance.

19. The Board discussed its IAS 20 project in February 2006. At that meeting, the Board decided to defer the IAS 20 project until further work is completed on other projects (in particular, the project to amend IAS 37 Provisions, Contingent Liabilities and Contingent Assets). Because the Board decided that the Emissions Trading Schemes project should be conducted concurrently with the IAS 20 project, work on the former was also deferred.

20. In December 2007, the Board activated work on the Emissions Trading Schemes project. The Board noted the increasing international use of emissions trading schemes and the considerable diversity in practice that appears to have arisen in the absence of authoritative guidance. In addition, the Board noted that it has received requests from several national standard-setters to address the topic and that the FASB has added an Emissions Allowances project to its agenda, providing the boards with an opportunity to co-ordinate their efforts in this area. The Board decided to limit the scope of the project to the issues that arise in accounting for emissions trading schemes, rather than addressing broadly the accounting for all government grants (which would have involved activating the IAS 20 project).

21. At its May 2008 meeting, the Board discussed the scope of the Emissions Trading Schemes project. It tentatively decided to address the accounting of all tradable emissions rights and obligations arising under emissions trading schemes. In addition, it will address the accounting of activities that an entity undertakes in contemplation of receiving tradable rights in future periods, eg certified emissions reductions (CERs). The Board confirmed that in addressing the accounting issues the staff should not be constrained by existing IFRSs, but the Framework would still be relevant.

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