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STAFF PAPER

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IASB Meeting

Project	**Pollutant Pricing Mechanisms (formerly Emissions Trading Schemes)**		
Paper topic	Why do we need a fresh approach?		
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Purpose of the paper

1. In January 2015, the IASB decided to take a fresh approach to looking at how to account for pollutant pricing mechanisms. In this meeting, the staff want to encourage the IASB members to think freely about how best to reflect the economic substance of a specific type of pollutant pricing mechanism; that is, a cap-and-trade type of emissions trading scheme (ETS).

2. At this time, we do not want the IASB's thinking to be restricted by existing Standards or past efforts or analysis. We are looking for the IASB to express non-binding, free-thinking ideas as a first-step to developing our thinking about which possible accounting models could be developed for consideration in a Discussion Paper about this project.

3. The purpose of this paper is to highlight some of the difficulties encountered in earlier approaches to the issue, which tried to fit emission allowances and the related obligations created by the mechanisms into existing Standards. The paper is intended to provide context to the staff's ongoing analysis. The staff do not have any specific questions on the contents of this paper for the IASB. The paper is provided as background information to aid the discussion about the various accounting treatments outlined in Agenda Paper 6B.

4. The paper focuses on one type of pollutant pricing mechanism, a cap-and-trade type of ETS. This is the most common and, perhaps, best known type of scheme

and was the focus of the IASB's previous projects. The staff would like to focus on addressing the issues raised by this type of scheme before moving on to other pollutant pricing mechanisms.

Background

5. The European Union Emissions Trading System (EU ETS) is the first—and still the biggest—international system for trading greenhouse gas emission allowances. The EU ETS covers more than 11,000 power stations and industrial plants in 31 countries, as well as airlines.[1] The EU ETS started in January 2005.

6. In 2002, the IFRS Interpretations Committee ('the Interpretations Committee') decided that it should develop an interpretation to explain how entities should apply IFRS to cap-and-trade schemes such as the EU ETS.[2] This decision was in response to questions raised about the appropriate accounting for the proposed EU ETS, in particular about the accounting treatment for allowances issued for less than fair value, commonly free of charge, by government.[3]

7. In December 2004, the Interpretations Committee issued the Interpretation IFRIC 3 *Emission Rights*, largely as exposed in the draft interpretation that was issued in May 2003. It specified that:

    (a) allowances are an intangible asset.

    (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 credit.[4]

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[1] See information provided by the European Commission on http://ec.europa.eu/clima/policies/ets/index_en.htm, extracted on 14 April 2015.

[2] A summary of the previous project is available to download at http://www.ifrs.org/Current-Projects/IASB-Projects/Emission-Trading-Schemes/Documents/Background_historyETS.pdf.

[3] In this paper, we use the term 'allowances' to denote the tradeable instruments issued for use in a variety of pollutant pricing mechanisms, including cap-and-trade emissions trading schemes. Other literature may use other terms (eg offsets, certificates, permits or rights) to mean the same.

[4] 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.

(c) 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.

(d) during the year, the entity amortises, on a systematic basis, the government grant (deferred credit) to profit or loss.

(e) 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.

8. Although few respondents agreed with the proposals in the draft interpretation, IFRIC 3 was issued in response to pressure from constituents about the lack of guidance on accounting for the EU ETS.

9. IFRIC 3 was withdrawn in June 2005. The IASB accepted that the accounting mismatches created by the requirements were likely to cause confusion and might not provide users of financial statements with relevant or understandable information about the financial positon and performance of entities that are subjects to ETSs. Since that time, a wide variety of accounting policies have been developed and applied in practice. Agenda Paper 6B provides numerical examples to demonstrate some of the most common policies seen in practice.

10. The remainder of this paper outlines some of the accounting issues that were considered in the development of IFRIC 3. These issues have remained unresolved since the withdrawal of IFRIC 3. We are providing the information only for background purposes. We are not asking the IASB to address them directly in this meeting. We expect that they will be addressed as we develop the thinking for any possible accounting models to be included in the Discussion Paper.

What are the accounting issues and why are they problematic?

11. ETS are mechanisms used by governments to reduce emissions of specified pollutants. The schemes are designed to put a price on what was previously

considered a freely available 'public good', that is, clean air. Historically, entities were able to operate without a monetary value being attached to the pollutants emitted into the air.

12. In some cases, penalties have been imposed on entities for pollutants emitted into water or onto land and obligations have been imposed on entities to clean up environmental damage caused by the emission of pollutants into water or onto land. Accounting for the monetary liabilities arising from such penalties or obligations has been adequately addressed by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

13. However, ETS introduced new economic effects around environmental protection measures. Governments recognised that imposing a new cost on what was previously a free activity could be economically damaging, not merely for the individual entities that are subject to the scheme but for a country's economy as a whole. Consequently, when introducing a new ETS, many governments have tried to reduce the short-term impact by providing compensation to entities in the form of allocations of allowances free of charge.

14. In many cases, the allocation of allowances free of charge negates, for the participant entities, the immediate cost of the scheme being introduced. However, over time, the volume of free allowances is reduced to incentivise the participants to reduce the overall level of the specified pollutants being emitted.

15. The staff consider that the compensatory nature of the allowances allocated free of charge, together with the interaction of the allowances and the participants' obligation to remit to the government allowances equal to the volume of their pollutant emissions, create a unique economic effect. This economic effect cannot, in the staff's view, be readily addressed using existing Standards.

16. Instead, a fresh approach is needed to identify the nature of the rights and obligations and, consequently, the related assets and liabilities created by the scheme. Once the nature of the assets and liabilities is identified, we can then look to develop an accounting model to best reflect them in IFRS financial statements. At this time, it is too early to suggest whether this model can be developed as an Interpretation of existing Standards, or whether it will need to be developed through amendments to existing IFRS.

17. Before we can look at when to recognise, and how to measure, the assets and liabilities created by ETS, we need to identify the nature of the assets and liabilities.

What type of asset is an emissions allowance?

18. The staff think that there is general acceptance that emissions allowances meet the definition of an asset in the IASB's *Conceptual Framework*. This is because:

    (a) they are economic resources;

    (b) they are controlled by the entity, and

    (c) they are expected to result in the economic benefits flowing to the entity because they can either be sold or be used to settle the entity's obligation to submit a determinable number of allowances to the scheme administrator at the end of the compliance period.

19. Although there seems to be general acceptance that the emissions allowances are assets, questions arise over the nature of the asset. This is partly because of the different ways in which the entity can use them to obtain economic benefits. This has resulted in different parties suggesting that the allowances have characteristics of different types of assets. Consequently, different accounting treatments that are used in practice tend to reflect different views about the nature of the allowances, based on how the allowances are expected to be used. This has also led to some 'mixed model' approaches in which an entity's allowances are accounted for in different ways, depending on which use they are expected to be put, despite the allowances being homogeneous in nature and fully interchangeable.

20. The variety of accounting treatments seen in practice reflect the accounting treatment in existing Standards of three different types of asset classifications:

    (a) Financial assets—IFRS 9 *Financial Instruments*;

    (b) Intangible assets—IAS 38 *Intangible Assets*; and

    (c) Inventories—IAS 2 *Inventories*.

21. In Europe, trading in emission allowances and related derivative instruments, such as forward contracts, is governed by the Markets in Financial Instruments

Directive (MiFID). However, in bringing the allowances within the scope of the MiFID, the European Commission noted that this does not mean that they are classified as financial instruments for accounting purposes. As the European Commission has stated, the 'Classification of emission allowances for accounting purposes depends on the criteria set by accounting standards only'.[5]

22. EUAs have some characteristics that are similar to financial instruments. We have heard a suggestion that they are similar to a currency, which is used to settle the obligation to submit EUAs to avoid paying a fine. In New Zealand, we understand that the government accounts for the issue of its emission allowances in the same way as it accounts for the issue of currency.

23. However, in developing IFRIC 3, the Interpretations Committee concluded that EUAs do not meet the definition of a financial instrument in accordance with IFRS. They are not equity instruments, nor do they give rise to contractual rights to receive cash or other financial assets. They are not derivatives. They do not require an initial investment that is smaller than would be required for other types of contract that would be expected to have a similar response to changes in market factors. They are not settled at a future date.

24. The Interpretations Committee concluded that allowances did meet the definition of an intangible asset in paragraph 8 of IAS 38; that is, 'an identifiable non-monetary asset without physical substance'. Consequently, IFRIC 3 required allowances to be classified as intangible assets and accounted for in accordance with IAS 38. However, the Interpretations Committee did acknowledge, in paragraph BC16 of the Basis for Conclusions on IFRIC 3, that allowances have some features that are more commonly found in financial assets than in intangible assets.[6] Such distinguishing features may, the Interpretations Committee noted, justify identifying a subclass of intangible assets that have value only because they are used to settle obligations. This separate class of intangible asset, it was noted, may be better presented in financial statements using a different accounting

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[5] *Review of the Markets in Financial Instruments Directive (MiFID)* and *Proposals for a Regulation on Market Abuse and for a Directive on Criminal Sanctions for Market Abuse: Frequently Asked Questions on Emission Allowances*, http://europa.eu/rapid/press-release_MEMO-11-719_en.htm?locale=en, 20 October 2011, accessed 5 April 2014.

[6] Extracts from the Basis for Conclusions on IFRIC 3 are reproduced in the appendix for convenience.

treatment than permitted by the existing cost or revaluation model contained in IAS 38.

25. This difficulty in classifying allowances in the same way as other intangible assets was highlighted in a case heard in the High Court in England and Wales in 2012. In that case, the judge, Mr Stephen Morris QC, considered the nature of European Union Allowance (EUAs) in law as property.[7] There was no dispute between the parties that EUAs a constitute property as a matter of law. What was at issue, however, was their precise nature and characterisation as property, because the classification could have an effect on the nature of the legal remedies available.

26. Mr Morris noted that ‘At the heart of the legal difficulties to which this case gives, or may give, rise is the somewhat novel nature of a European Union Allowance (EUA). This novelty arises from two particular features: the first is that an EUA is a creature of European legislation and the second is that an EUA exists only in electronic form’.

27. Consequently, the case does not conclude on the precise category of asset to which EUAs should be classified, but Mr Morris observed;

> ‘As a matter of substance, [an EUA] does not give the holder a "right" to emit CO_2 in this sense. Rather it represents at most a permission (. . .) or an exemption from a prohibition or fine. But for the entitlement to the EUA, the holder would either be prohibited from emitting CO_2 beyond a certain level or at least would be required to pay a fine if he did so. In this way, the holding of the EUA exempts the holder from the payment of that fine.
>
> An EUA is a creature of the ETS. As a matter of form an EUA exists only in electronic form. It is transferable automatically by electronic means within the registry system. Under the ETS legislation it is transferable under the terms of the ETS Directive. It has economic value, first because it can be used to avoid a fine, and secondly, because there is an active market for trade in EUAs.’

[7] Armstrong DLW GmbH v Winnington Networks Ltd [2012] EWHC 10 (Ch) (11 January 2012).

28. Although the judgement in Armstrong DLW GmbH v Winnington Networks Ltd [2012] concluded that EUAs could be considered to be intangible assets, it highlighted that they do not have the typical characteristics normally associated with other intangible assets.[8] As noted by Mr Morris QC, the EUAs do not give the entity a right to emit greenhouse gases (GHGs).

29. This difficulty in determining the precise nature of the EUA and how to classify it as an asset is reflected in the different accounting treatments that are seen in commonly used accounting treatments. The most common classification is as an intangible asset, but others classify them as inventory.

30. Some consider EUAs to have similar economic characteristics to commodities, which can either be traded or be used for compliance purposes in the production process. This has led to some entities treating the emission allowances that they hold for compliance purposes in the same way as normal inventory, in accordance with IAS 2. This means that the allowances are recognised at cost (which is commonly a combination of nil for those allowances received free of charge from the government plus the acquisition cost for those purchased through a government auction or from traders in the market). IAS 2 is also used for emission allowances that are held for trading (either allowances acquired for such purposes or those held in excess of the number of allowances needed for compliance purposes). This can result in the 'trading' allowances being measured at fair value through profit and loss in the same way as a commodity broker-trader measures its inventory of commodities acquired for trading purposes.

What is the nature of any liability created for a participant in a cap-and-trade ETS?

31. Some suggest that, when an entity receives allowances free of charge from the government, it should recognise an immediate gain in profit or loss equal to the value of the allowances received. The measurement of the value is discussed later in this paper (see the section starting at paragraph 40).

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[8] IAS 38 *Intangible Assets* defines an intangible asset as 'an identifiable non-monetary asset without physical substance'.

32. The recognition of a Day 1 gain is supported by the following arguments. The entity has received a grant from the government in the form of the allowances:

   (a) The grant is conditional on the entity being a participant in the scheme when the allowances are granted. Consequently, as long as the entity was operating on the date that the allowances were granted, it has satisfied the conditions of the grant. This is particularly so for participants within a scheme that does not require the return of allowances to the government based on a pro rata time basis if a participant closes an installation covered by the scheme during the compliance period.

   (b) The grant is intended to provide compensation to the entity for the introduction of the scheme and the consequential possible impairment of the value of the business being operated in the installation covered by the scheme. This argument is based on the notion that the entity previously was able to emit pollutants without restrictions. The introduction of the scheme has created a restriction on the way that the business is operated, which will increase the cost of production in future periods.

   (c) Although the entity will need to remit allowances to the government that equal the volume of the specified pollutants actually emitted in the compliance period, the entity is not obliged to continue to emit the specified pollutants. In developing IFRIC 3, the Interpretations Committee concluded that the obligating event is the emitting of the pollutant. Consequently, the cost of any allowances required to be remitted to the government is a future operating cost that is within the entity's control. In accordance with IAS 37, no liability should be recognised until the entity emits the specified pollutants throughout the period. The liability then recognised will reflect the volume of emissions made to date.

33. When developing IFRIC 3, the Interpretations Committee first considered when a liability arises for the obligation to deliver allowances equal to the volume of actual emissions. It relied on paragraph 19 of IAS 37 to support its conclusion

that a liability for this obligation arises only as emissions are made. Paragraph 19 states: 'it is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions'.

34. Having concluded that there is no liability to deliver allowances at the start of the compliance period when allowances are received free of charge from the government, the Interpretations Committee then considered if there is an element of government grant.

35. Subsequently, the Interpretations Committee concluded that the obligation imposed by the scheme to reduce emissions or deliver allowances is a condition 'relating to the operating activities of the entity' (paragraph BC26 of IFRIC 3). The Interpretations Committee also concluded that the grant is intended to compensate the entity for higher operating costs in the compliance period. As a result, IFRIC 3 required the grant to be recognised initially at the fair value of the allowances received. It then required that the deferred grant income should be amortised on a systematic basis over the compliance period for which the allowances were allocated.

36. However, some may suggest that the recognition of a Day 1 gain on receipt of allowances free of charge from the government may be a valid accounting treatment. So far, the staff have not found evidence that this accounting treatment is commonly applied. Instead, a variety of accounting policies have been developed that either:

    (a) recognise the allowances initially at fair value and recognise a corresponding liability in the statement of financial position in the form of a government grant, which is amortised systematically to income as pollutants are emitted. The allowances are measured subsequently at either cost or fair value. A separate liability then accumulates as the entity emits the specified pollutants during the period.

    (b) recognise the allowances initially and subsequently at nil cost. A separate liability then accumulates as the entity emits the specified pollutants during the period. However, the liability is not recognised (or is recognised at nil cost) if the allowances on hand are expected to at

least equal the volume of allowances expected to be required to be remitted to the government for the pollutants emitted in the compliance period.

37. As noted in paragraphs 44–45, the accounting policies adopted to measure the liability differ.

Which measurement approach best reflects the economic effects of emission allowances?

38. Having classified the allowances received free of charge as an intangible asset, the government grant as a deferred income credit and the liability to deliver allowances as a provision that accrues as pollutants are emitted, the Interpretations Committee concluded that it was unable to modify the measurement requirements of the relevant Standards. Consequently, IFRIC 3 required that:

   (a) the allowances should be measured initially at fair value, as a deemed cost, and subsequently at cost or revalued amount, less any impairment, in accordance with IAS 38;

   (b) the government grant should be measured initially at the same amount as the corresponding allocation of allowances (less the price paid, if any) and should then be amortised on a systematic basis in accordance with IAS 20; and

   (c) the provision should be measured at the best estimate of the expenditure required to settle the present obligation at the reporting date, which would normally be the present market price of the number of allowances required to cover the emissions made to date, in accordance with IAS 37.

39. Many of the respondents to the Exposure Draft that preceded IFRIC 3 were concerned about the resulting mixed measurement model of the Interpretation.[9] Since its withdrawal, a variety of measurement models have developed in practice.

[9] Examples 1 and 2 in the accompanying Agenda Paper 4B demonstrate the accounting requirements that were contained in IFRIC 3.

Measuring the emissions allowances and related obligations

40. It seems reasonable to conclude that measuring emissions allowances at fair value less costs to sell through profit or loss is likely to be most appropriate when such allowances are used exclusively for trading. For entities that act merely as broker-traders in emissions allowances, such treatment could be readily achieved by the IASB determining that allowances held by broker-traders should be classified as inventory, as referred to in paragraphs 3(b) and 5 of IAS 2 (see paragraph 30 of this paper).

41. However, many consider such an approach to introduce unjustified volatility to the financial results of an entity that uses emissions rights only to comply with its obligations to submit allowances equal to the volume of its pollutant emissions during the compliance period. Those holding this view frequently suggest that it is more appropriate for entities that are required to obtain allowances to cover the emissions resulting from their production activities to measure their allowances at cost.

42. The question then arises as to what is meant by ‘cost’. IFRIC 3 required that for allowances received from the government free of charge or at a discounted price, the allowances should initially be recognised at fair value as deemed cost. Some suggest that cost should be the price paid to acquire the allowances. This approach results in any allowances received from the government free of charge being recognised at nil cost—effectively this means that they are not recognised in the statement of financial position.

43. As well as different views about the measurement of the allowances, accounting policies applied in practice demonstrate different views about the preferred measurement of the provision for the obligation to deliver allowances to the government to cover the volume of emissions made during the compliance period.

44. In one approach, the liability is measured based on the market value of allowances at each reporting date that would be required to cover the actual emissions to date, regardless of whether the allowances are on hand or would be purchased from the market. This approach is based on the requirements of IAS 37.

45. In another approach, the liability is measured based on the carrying amount of allowances on hand at each reporting date to be used to cover actual emissions to

date. If actual emissions exceed the number of allowances on hand, the market value of allowances at each reporting date is used to measure the additional allowances that would be required to cover any excess emissions. Using this approach, the allowances on hand are measured using a first in, first out (FIFO) or weighted average cost basis.

Conclusion

46. When developing IFRIC 3, the Interpretations Committee was constrained by its remit to interpret ETS within the context of existing Standards. This required that the emissions allowances were classified into one type of asset class and the existing recognition and measurement requirements of existing Standards were then applied in according with the classification selected.

47. In taking a fresh approach to the issues, the staff would like the IASB to focus initially on the financial or economic effects of ETS and how best to report those effects. At this stage, we are looking at generating thought-provoking ideas about possible approaches. The staff will then analyse any possible models that the IASB would like to explore in more detail through the Discussion Paper. This analysis will involve comparison to the concepts in the *Conceptual Framework* and the existing requirements of IFRS.

Questions for the IASB

48. The staff do not have any specific questions on the contents of this paper for the IASB. The paper is provided as background information to aid the discussion about the various accounting treatments outlined in Agenda Paper 6B.

Question to the IASB
Does the IASB have any questions or comments on the contents of this agenda paper?

Appendix—Extract from the Basis for Conclusions on IFRS Interpretation 3 (IFRIC 3) *Emission Rights* (withdrawn June 2005).

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IFRIC 3.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background

BC2 The IFRIC noted that several governments have, or are developing, schemes to encourage reduced levels of emissions. In particular, schemes are being developed to encourage reductions of greenhouse gas emissions in the light of the Kyoto agreement, which comes into effect in 2008. Some such schemes are based on a cap and trade model as described in paragraph 1 of the Interpretation.

BC3 The IFRIC observed that many companies are, or will be, subject to such schemes. In particular, the IFRIC noted that a European Union scheme for greenhouse gas emissions trading will start in 2005. It also noted that there is at present no guidance on the accounting for such schemes. The IFRIC was informed that no consensus had emerged among market participants on what the accounting treatment should be. Because there is a risk of divergent practices developing, the IFRIC concluded that it should develop an Interpretation. As part of that process, the IFRIC published Draft Interpretation D1 *Emission Rights* for public comment in May 2003 and received 40 comment letters in response to its proposals.

BC4 Most respondents to D1 supported the IFRIC's proposal to develop an Interpretation. However, although agreeing that the IFRIC should add the topic to its agenda, some respondents suggested that the IFRIC should not finalise its proposals at present. Two main reasons were given:

(a) emission rights schemes are in their infancy. Therefore, the IFRIC should wait until the design of the various schemes becomes clearer so that, if necessary, the Interpretation could deal with a broader range of accounting issues.

(b) the International Accounting Standards Board has on its active agenda a project to amend IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. Given that IAS 20 is an important reference for the Interpretation, the IFRIC should wait until it is able to interpret the revised IAS 20.

BC5 In considering these comments, the IFRIC initially decided to defer finalising its Interpretation pending (a) the Board's project to revise IAS 20 and (b) a possible amendment of IAS 38 *Intangible Assets* to require allowances to be measured at fair value with changes recognised in profit or loss (this possible amendment is discussed in paragraph BC18 below). However, it became clear that these changes could not be made before a number of schemes started. The IFRIC concluded that the need for timely guidance to prevent divergent practices developing outweighs the disadvantage that the Interpretation might be amended in the medium term. It therefore decided to finalise its Interpretation. It acknowledged that the Interpretation might need to be amended if the Board amends IAS 20 or IAS 38, but noted that any such amendments would be made as consequential amendments by those revised Standards.

Scope and issues

BC6 The IFRIC noted that there is no universal form of scheme being developed. Rather, individual countries (or, in some cases, groups of countries) are developing schemes tailored to local circumstances. As a result, features that are present in some schemes are not present in others. The IFRIC therefore decided to address the three main accounting issues raised by a generic cap and trade scheme (as set out in paragraph 4 of the Interpretation). The IFRIC understands that such schemes have features that are common to most schemes and that, at present, those features give rise to the biggest issues in practice.

BC7 Whilst focusing on a cap and trade scheme, the IFRIC has highlighted that the requirements of the Interpretation might be relevant to other schemes designed to reduce emissions. The IFRIC noted that although other schemes may not have all of the features outlined in paragraph 1, or may have additional features, they are likely to raise some of the accounting issues addressed in the Interpretation, particularly the question of whether there is a net asset (or liability) or a separate asset and liability. The IFRIC believes that, in accordance with paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, an entity should take account of the Interpretation in developing and applying an appropriate accounting policy for other emission reduction schemes.

BC8 Some respondents to D1 asked the IFRIC:

(a) to explain how its requirements apply to other schemes (eg renewable energy certificates and baseline schemes); and

(b) to consider some additional questions raised by cap and trade schemes (including, for example, the accounting treatment of non-cash penalties, measurement of allowances and obligations to deliver allowances when there is no active market for allowances, and the recognition and measurement of impairment losses).

BC9 However, the IFRIC observed that the additional questions that it was being asked to consider were not the most significant issues in practice or were not specifically relevant to emission rights schemes. The IFRIC therefore confirmed its view that the Interpretation should address the three issues set out in paragraph 4. Nonetheless, the IFRIC agreed that, if necessary, it would supplement the Interpretation to deal with any further matters requiring authoritative guidance once more experience has been gained with emission rights schemes.

BC10 The IFRIC noted that some companies that are not yet subject to such a scheme but expect to be subject to such a scheme in the future are buying emission rights in the hope of being able to use them in a future scheme. Also, some companies are entering into contracts for emission 'credits', ie emission rights that are not yet verified. For example, a company may pay a cash sum to a second company to enable that second company to undertake a project to reduce emissions, which it is hoped will result in verified emission rights that would then be delivered back to the first company. The IFRIC noted that these cases raise the question whether allowances should be recognised as assets. Because the IFRIC also did not regard this question as one of the most important issues in practice at present, it decided to limit the scope of the Interpretation to participants in a scheme that is operational.

Consensus

Does a cap and trade scheme give rise to (i) a net asset or liability or (ii) an asset (for allowances held) and a liability, deferred income and/or income?

BC11 In D1 the IFRIC proposed that a cap and trade scheme gives rise to an asset (for allowances held) and a liability, deferred income and/or income. Although most respondents agreed with this proposal, some argued that a cap and trade scheme gives rise to a net position. They suggested that a participant that produces emissions to the extent of its allowances should not recognise either an asset for allowances issued free of charge, or a liability for its emissions. Instead, they proposed that the participant should recognise a liability only when it has produced emissions and holds insufficient allowances to cover them (or, recognise an asset when it holds allowances in excess of its requirements). Those respondents argued that accounting for an emission rights scheme in this way would reflect that a participant that produces emissions to the extent of its allowances is acting in accordance with the rights granted to it, whereas a participant that produces emissions in excess of its allowances is obliged to acquire additional allowances.

BC12 The IFRIC rejected these arguments and decided that its original arguments for concluding that an emission rights scheme gives rise to an asset (for allowances held) and a liability, deferred income and/or income were valid. In support of its conclusion, the IFRIC noted:

- An allowance meets the definition of an asset in the *Framework*, namely it is 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.' This is evidenced by the nature of an allowance as a transferable certificate, which the participant can either sell or use to settle an obligation.
- Once emissions have occurred the participant has a liability within the definition in the *Framework*, namely it has 'a present obligation … arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.' The obligation is to deliver allowances.
- The allowance and the obligation exist independently. Although a participant may *intend* to use the allowances it holds to settle its obligation, it cannot be compelled to do so. Instead it may choose to sell allowances and either reduce emissions or buy allowances at a future date. Thus, there is no contractual link between the asset and the liability, even though many participants will hold the allowances solely for the purpose of settling their obligations.
- Under some schemes, participants need to hold an emissions permit in order to produce emissions. This confirms that an allowance itself does not confer a right to emit. Rather it is the instrument that must be delivered in order to settle the obligation that arises from emissions.
- In some cases, a participant may be able to choose which of a number of different allowances (issued under different schemes) it uses to settle its obligation. This feature is likely to become more common as schemes are developed in various countries, with the ability to use allowances issued under one scheme to settle obligations arising in another.
- A cap and trade scheme does not merely represent a 'tax' on emissions in excess of the cap. An important feature of a cap and trade scheme is the ability it gives participants to trade allowances. Accordingly, some participants will purchase allowances from other participants for cash and recognise these purchased

allowances as assets. However, purchased allowances are indistinguishable from those issued by government, which confirms that allowances issued by government are assets in their own right.

- There is no right of offset between the allowances and the obligation to deliver allowances, nor is there a debtor/creditor relationship. It is therefore inappropriate to offset the asset and liability.

What is the nature of the asset for allowances held by participants?

Is the asset within the scope of IAS 38 or IAS 39?

BC13 The IFRIC concluded that allowances held by participants are intangible assets within the scope of IAS 38, because they meet the definition of an intangible asset in paragraph 8 of IAS 38: 'an identifiable non-monetary asset without physical substance.'

BC14 Some respondents disagreed with this conclusion and suggested that allowances should be accounted for as financial assets under IAS 39 *Financial Instruments: Recognition and Measurement*. Some also proposed that the allowance should then be treated as the hedging instrument of a forecast transaction (ie future emissions). However, the IFRIC noted that:

- Allowances do not meet the definition of a financial asset in IAS 32 *Financial Instruments: Disclosure and Presentation*, since they are neither equity instruments nor contractual rights to receive cash or other financial assets.
- Allowances do not fall within the scope extension in IAS 39 for contracts to buy or sell a non-financial item, since they are not a contract to buy or sell a non-financial item.
- Allowances are not a derivative because they do not have 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' and are not 'settled at a future date'. Therefore, they cannot be designated as a hedging instrument. (The fact that the allowances may be instruments obtained by the entity free of charge does not mean that they have 'no initial net investment'.)
- Being readily tradeable does not make allowances financial assets any more than, say, a readily tradeable commodity.

BC15 The IFRIC therefore concluded that it could not *interpret* allowances as falling within the scope of IAS 39. It also concluded that it would be inappropriate to ask the Board to amend the scope of IAS 38 and IAS 39 to bring allowances within the scope of IAS 39.

BC16 Nonetheless, the IFRIC acknowledged that allowances have some features that are more commonly found in financial assets than in intangible assets. In particular, many are traded in a ready market and are a mechanism for 'pricing' a particular product (eg a tonne of carbon dioxide). Some respondents to D1 therefore suggested that allowances would be best measured at fair value with changes in value recognised in profit or loss. Those respondents were particularly troubled about the mismatch that would arise in profit or loss if allowances were accounted using the cost model in IAS 38, because IAS 37 requires the liability for the obligation to deliver allowances to be measured at a current value. Furthermore, they noted that even if allowances were measured at fair value using the revaluation model in IAS 38, there would be a mismatch in the recognition of changes in the assets and liabilities. This is because changes in the value of the allowances above cost would be recognised in equity, whereas changes in the liability are recognised in profit or loss.

BC17 When the IFRIC developed D1, it noted that the Board was considering removing the present distinction between changes in value recognised in equity and those recognised in profit or loss as part of its project on reporting financial performance. For a participant using the revaluation model in IAS 38, this would have alleviated some of the mismatch referred to above. However, during its redeliberations the IFRIC noted that the Board had revised the timetable for the project on reporting financial performance, and thus that the distinction of recognising some changes in value in profit or loss and others in equity is likely to remain for some time.

BC18 In the light of this, the IFRIC considered whether it should ask the Board to amend IAS 38 so that *all* changes in the value of an allowance measured at fair value would be recognised in profit or loss. The IFRIC noted that the Board would be unlikely for two reasons to reconsider the recognition of changes in value of all intangible assets under the revaluation model in IAS 38: this treatment is the same as IAS 16 *Property, Plant and Equipment* and the Board has a research project on intangible assets. Therefore, to justify an amendment to IAS 38 the IFRIC reasoned that it would need to distinguish allowances from other intangible assets that qualify to be measured subsequently at fair value. The IFRIC noted that it might be possible to identify a subclass of currency-like intangible assets (to include allowances), ie intangible assets that have value only because they are used to settle obligations. However, the IFRIC concluded that it would not be possible to formulate, expose and finalise an amendment to IAS 38 in time for 2005.

Should allowances be amortised?

BC19 Having concluded that allowances fall into the scope of IAS 38, the IFRIC proposed in D1 that allowances should not be amortised but should be tested for impairment in accordance with IAS 36 *Impairment of Assets*.

BC20 Many respondents to D1 disagreed with the conclusion that allowances should not be amortised. Some respondents suggested that the allowance represents a right to produce emissions and therefore that a participant should amortise its allowances as it produces emissions to reflect the consumption of that right. Other respondents broadly agreed with the IFRIC's proposal but noted that the IFRIC's basis for non-amortisation, which was that the residual value of an allowance would be the same as its cost (or revalued amount), would apply only if the allowances were traded in an active market. This is because paragraph 100 of IAS 38 states that the residual value should be assumed to be zero unless there is a commitment by a third party to purchase the asset at the end of its useful life or an active market for the asset.

BC21 As noted in paragraph BC12, the IFRIC concluded that an allowance is not a right to produce emissions and it has confirmed this view with scheme administrators. The allowance is the instrument that a participant surrenders to settle its obligation that arises from its emissions. It therefore follows that a participant in a cap and trade scheme does not consume the economic benefits of an allowance as a result of its emissions. Rather, a participant realises the benefits of that allowance by surrendering it to settle the obligation that arises from producing emissions (or by selling it to another entity). Therefore, the IFRIC observed that amortisation, which is the systematic allocation of the cost of an asset to reflect the consumption of the economic benefits of that asset over its useful life, is incompatible with the way the benefits of the allowances are realised. Although the IFRIC agreed that this observation pointed to precluding amortisation, it agreed with those respondents who highlighted that in some cases such a requirement could be inconsistent with the requirements of IAS 38. The IFRIC therefore decided not to proceed with its proposal in D1 that allowances should not be amortised. Nonetheless, for most allowances traded in an active market, no amortisation will be required, because the residual value will be the same as cost and hence the depreciable amount will be zero.

What is the nature of the separate liability, government grant and/or income that is recognised and how is it measured?

When is a liability recognised?

BC22 The IFRIC discussed when a liability arises for the obligation to deliver allowances equal to actual emissions. The IFRIC concluded that a liability for this obligation arises only as emissions are made. This follows from IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which states that there is no liability until an 'obligating event' occurs. In an emission rights scheme, the obligating event— ie the event that obliges the entity to deliver allowances—is the production of emissions (not the receipt of allowances). At the start of the compliance period when allowances are issued this has not yet happened, and hence there is no liability for the obligation to deliver allowances. This view is supported by paragraph 19 of IAS 37, which states: 'It is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions.' The IFRIC noted that the obligation to deliver allowances depends entirely on the participant's future actions, ie whether it produces emissions.

BC23 The IFRIC therefore concluded that once emissions are made, a liability will arise that should be accounted for in accordance with IAS 37. Those respondents to D1 who argued that allowances represent a right to produce emissions (ie those who proposed a net model—see paragraph BC11—or those who proposed that allowances should be amortised as the entity produces emissions—see paragraph BC20) disagreed with this conclusion. They argued that a liability arises only when a participant holds insufficient allowances to cover its emissions (ie it has produced emissions outside its allowed right) and is therefore obliged to acquire additional allowances. However, as noted in paragraph BC21, the IFRIC observed that an allowance is not a right to produce emissions. Rather, it is the instrument that is surrendered to government in order to settle the obligation that arises from emissions. This obligation is incurred regardless of whether the participant holds allowances. The fact that a participant may hold assets to meet its obligation for emissions does not relieve the participant of that obligation.

How should the liability be measured?

BC24 The Interpretation specifies that the obligation to deliver allowances for past emissions will normally be measured at the present market price of the number of allowances required to cover emissions made at the balance sheet date. The IFRIC's view is that this follows 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.' This is described as the amount that an entity would rationally pay to settle the obligation or to transfer it to a third party.

BC25 Some respondents to D1 disagreed with this interpretation of IAS 37. They argued that the 'best estimate' could be interpreted to refer to the cost of the allowances held by the participant rather than their current market price. However, the IFRIC noted that the cost of allowances (or their initial fair value, if issued for less than fair value) is 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. The IFRIC also noted that liabilities are measured independently of how those liabilities will be funded.

Government grant

BC26 Having concluded that there is no liability to deliver allowances at the start of the compliance period when allowances are issued, the IFRIC then considered if there is an element of government grant. The IFRIC concluded that the issue of allowances for less than their fair value (eg free of charge) gives rise to a government grant. Such an award

comes within the definition of a government grant in IAS 20: 'assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.' In particular, the IFRIC noted that the obligation imposed by an emission rights scheme to reduce emissions or deliver allowances is a condition 'relating to the operating activities of the entity.' It also noted that an award of allowances for less than their fair value comes within paragraph 23 of IAS 20: 'A government grant may take the form of a transfer of a non-monetary asset, such as land or other resources, for the use of the entity.'

BC27 The IFRIC decided that when allowances are issued for less than fair value, they should be recognised initially at their fair value. The IFRIC acknowledged that IAS 20 would permit allowances issued for less than fair value to be recognised at the amount paid for them. However, the IFRIC observed that if this treatment were adopted, participants would not recognise allowances issued free of charge on their balance sheet but they would recognise purchased allowances. The IFRIC concluded that this treatment would not be a faithful representation of the resources controlled by the participant, because purchased allowances are indistinguishable from those issued free of charge.

BC28 Whilst not necessarily disagreeing with the IFRIC's conclusion, some respondents to D1 argued that, in precluding participants from recognising allowances issued for less than fair value at the amount paid for them, the IFRIC was eliminating a choice of accounting treatment from IAS 20. Consequently, in their view, IFRIC was amending a Standard. In its redeliberations, the IFRIC noted that the treatment it was requiring did not conflict with IAS 20. Given this, and because the IFRIC believes that initially recognising allowances at an amount other than their fair value would be inappropriate, the IFRIC reaffirmed its decision to measure the grant and allowances initially at fair value.

BC29 The IFRIC also discussed what method should be used to recognise the grant as income and where in the balance sheet (ie as a deferred credit or as a reduction in the carrying amount of an asset) the grant should be presented if not recognised as income on initial recognition. It noted that paragraph 12 of IAS 20 requires grants to be recognised in income 'over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis.' The question therefore is: what are the costs that an award of allowances for less than fair value is intended to compensate for?

BC30 The IFRIC noted that the grant is intended to compensate for higher operating costs in the compliance period. Accordingly, the IFRIC agreed that the grant should initially be recognised as deferred income in the balance sheet. Subsequently the requirement in paragraph 12 of IAS 20 is met by amortising the deferred income on a systematic basis over the compliance period for which the allowances were allocated. The IFRIC observed that any relationship between the allowances and a compliance period other than the one for which they were allocated would be tenuous. The IFRIC also observed that the appropriate amortisation method will depend on how the participant chooses to respond to the emission rights scheme, and accordingly decided that it should not specify a particular method.

BC31 A few respondents to D1 asked the IFRIC to clarify the accounting treatment for the outstanding deferred credit if a participant sold its allowances. These respondents suggested that the outstanding deferred credit should be recognised in income to reflect the realisation of the grant. However, the IFRIC's view is that the grant has been awarded to compensate for the higher operating costs incurred as a result of being subject to a cap and trade scheme. The IFRIC therefore concluded that the deferred credit should not be derecognised when the allowances are sold and should continue to be amortised.

BC32 As discussed in paragraph BC16, many respondents were concerned about the mixed measurement model of the Interpretation. Whilst some noted that this could be dealt with by measuring allowances at fair value, with changes in value recognised in profit or loss, others noted that the effects of the mixed measurement model in profit or loss could be

fully addressed only by subsequently remeasuring the deferred credit to take account of changes in the market value of the allowances. However, the IFRIC concluded that since a deferred credit is not a liability under the *Framework*, it would be inappropriate for it to be remeasured.

Penalties

BC33 In D1, the IFRIC proposed that a (cash) penalty, which would be incurred if a participant fails to deliver sufficient allowances to cover its actual emissions, should be taken into account in measuring the provision for the obligation to deliver allowances. In other words, the IFRIC suggested that the obligation to deliver allowances could, in some circumstances, be settled by paying a cash penalty. Some respondents to D1 noted that it would be unusual for a cap and trade scheme to allow a participant to satisfy its environmental obligation with a cash payment. For example, in the EU emissions trading scheme, the penalty does not relieve the participant from its obligation to deliver allowances: the participant pays a penalty *and* delivers allowances the following year. The IFRIC therefore concluded that the penalty should be treated separately from the obligation to deliver allowances. It noted that the penalty would be within the scope of IAS 37 but decided there was no need to provide specific guidance on this point.

Impairment

BC34 The IFRIC noted that the existence of an emission rights scheme might cause certain assets to become impaired, since it might have the effect of reducing the future cash flows expected to arise from an asset (eg a power station) and hence reduce that asset's value in use. As noted in paragraph BC9 the IFRIC concluded that it should not provide guidance on recognition and measurement of impairment losses. Apart from noting that this issue was not specific to emission rights schemes, the IFRIC doubted whether it could add much to the present requirements in IAS 36. However, the IFRIC agreed it would be useful to include a reminder in the Interpretation that an emission rights scheme falls within the indication in paragraph 12(b) of IAS 36 that an asset may be impaired.

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