



30 Cannon Street, London EC4M 6XH, England
Phone: +44 (20) 7246 6410, Fax: +44 (20) 7246 6411
Email: iasb@iasb.org.uk Website: <http://www.iasb.org.uk>

International
Accounting Standards
Board

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Emission Trading Schemes

Project Updates are provided for the information and convenience of constituents who wish to follow the IASB's deliberations. All conclusions reported are tentative and may be changed as the project develops.

Introduction

This project report is structured as follows:

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Objective

1. The objective of the project is to develop comprehensive guidance on the accounting for emissions trading schemes, including (but not limited to) the following issues:
 - i Are emissions allowances assets? Is this conclusion affected by how the allowance is acquired? What is the nature of the allowance (eg licence to emit or form of emission currency)? If allowances are assets, should they be recognised and, if so, how should they be measured initially?
 - ii What is the corresponding entry for an entity that receives allowances from government free of charge? Does a liability exist? If so, what is the nature of the liability and how should it be measured both initially and subsequently?
 - iii How should allowances be accounted for subsequently? Is the existing model in IAS 38 *Intangible Assets* or IAS 39 *Financial Instruments: Recognition and Measurement* appropriate? If not, what is the appropriate accounting?

- iv When should an entity recognise its obligations in emissions trading schemes and how should they be measured? How does IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* apply?
 - v What are the overall financial reporting effects of the above decisions?
2. Among the reasons for adding the topic to the agenda, the Board noted in particular the increasing international use (or planned use) of schemes designed to achieve reduction of greenhouse gases through the use of tradeable permits. It also noted that there was a risk of diverse accounting practices for such schemes following the [withdrawal of IFRIC 3 *Emission Rights*](#) and that this would impair the comparability and usefulness of financial statement information.

Next Steps

3. The project team plans to bring a comprehensive package of alternative accounting models to the Board in the second quarter of 2010.

Background

Emissions trading

4. Schemes designed to achieve a reduction of greenhouse gases through the use of tradeable emission permits—emission trading schemes—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.
5. The theory behind emissions trading relies on the creation of value through the allocation of a right to emit pollutants. For example, 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 ‘allowances to emit’, each allowance granting 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 will normally be below actual levels of emissions currently being made by entities, creating scarcity. This scarcity creates value for the holders of such rights.
6. 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.
7. 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.

The IFRIC’s work: 2002-2004

8. 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)

9. 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.
10. 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).
11. 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*).
12. 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.
13. 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.

IFRIC 3

14. 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.

15. 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 CO₂, 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

16. 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 (ie a cash flow hedging model). The IFRIC's work and the EFRAG staff proposal were considered by the Board at its June 2005 meeting.
17. 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.
18. 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.

Agenda decision and project status

19. 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](#).
20. 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

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.

Schemes project should be conducted concurrently with the IAS 20 project, work on the former was also deferred.

21. 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).
22. 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.
23. At the joint Board meeting in October 2008, the boards discussed the accounting for emissions trading scheme:
 - the receipt of allowances in a cap and trade scheme
 - the baseline in a baseline and credit scheme

The session was educational and no decisions were made.

24. At the March 2009 meeting, the Board discussed the initial accounting for emission allowances that entities receive free of charge from government in cap and trade emission trading schemes.
 - Emission allowances: the Board decided tentatively that an entity should recognise emission allowances received free of charge from government as assets. The allowances should initially be measured at fair value.
 - Corresponding obligation: the Board decided tentatively that if an entity receives allowances free of charge from the government, the entity incurs an obligation to reduce its emissions below the level represented by those allowances (ie its cap). Only if the entity fulfils this obligation will it be entitled to retain some of the allowances. The Board decided tentatively that the entity should recognise a liability for this obligation. The liability is measured initially at the fair value of the allowances received.
25. At the joint Board meeting in November 2009, the boards discussed the accounting for emissions cap and trade schemes. The meeting focused on schemes with voluntary participation (voluntary schemes), which involve contracts between knowledgeable and willing parties.

The boards discussed the application to a voluntary scheme of the definitions of an asset and a liability in the FASB Concept Statements and in the IASB Framework. The boards focussed their discussion on two views as to when liabilities arise in such a scheme:

- View 1 is that an entity's actual emissions are the obligating event in a voluntary scheme. An entity does not incur a present obligation, and hence a liability, until it has emitted. Until emissions have occurred, the entity can take action that enables it to avoid delivering allowances.
- View 2 is that entering into the membership contract is the event that creates a liability (the obligating event). By signing the membership contract, the obligation to pay allowances is unconditional.

The staff did not ask the boards to make any decisions at this meeting, but did seek advice as to which view had the stronger initial support. Both boards indicated a preference for view 2.

26. At the December 2009 meeting, the Board discussed the accounting for the right to receive allowances in an emissions cap & trade scheme *before* the related allowances have been issued. The Board addressed the issue in relation to (a) schemes with voluntary participation (voluntary schemes), which involve contracts between knowledgeable and willing parties and (b) statutory schemes with mandatory participation.

Many emissions trading schemes split the commitment period into annual compliance periods. That means an entity:

- receives allowances under its allocation in yearly instalments at the beginning of each compliance year, and
- surrenders allowances at the end of each compliance year to offset its emissions in that compliance year.

The Board discussed two views on when an entity controls a resource related to its future instalments:

- According to View 1, an entity does not control a resource until the contingencies related to the right to receive allowances are resolved.
- According to View 2, an entity controls a resource when the entity holds a right that will result in the entity receiving allowances if the entity takes specified actions (typically, continuing to emit at a specified level). That right is an option and the entity exercises it by undertaking the specified actions.

The staff did not ask the Board to make any decisions at this meeting but asked the Board for direction in developing accounting guidance for emissions trading schemes.

Project history: Tentative decisions to date

27. In March 2009, the Board decided tentatively that an entity should recognise emission allowances received free of charge from government as assets. The allowances should initially be measured at fair value. The Board decided tentatively that if an entity receives allowances free of charge from the government, the entity incurs an obligation to reduce its emissions below the level represented by those allowances (ie its cap). The FASB discussed the project in April 2009. The FASB did not reach any conclusions on the accounting questions related to initial recognition and

measurement of emission allowances received free of charge from governments. Click [the](#) relevant date to view the decision summaries and observer notes for these meetings.

Meeting	Main topics discussed
December 2009	Accounting for the right to receive allowances in a cap and trade scheme
November 2009	Accounting for voluntary cap and trade schemes
March 2009	Accounting for emission allowances received free of charge
October 2008	Education session on accounting issues
May 2008	Scope of the project
Dec 2007	Consideration of whether to activate work on the project
Feb 2006	Consideration of whether to defer work on IAS 20 (thus deferring work on the Emissions Trading Schemes project).
Sep 2005	Consideration of whether to add project to the technical agenda

Contact Information

28. Staff contacts:

- Allison McManus (Project Manager): amcmanus@iasb.org