



To:	AASB Members	Date:	25 November 2009
From:	Joanna Spencer	Agenda Item:	16.4
Subject:	Emissions Trading – IASB Tentative Decisions	File:	

Action

To consider whether comment should be made to the IASB regarding the direction they appear to be taking on the Emissions Trading project, in particular, when a liability should be recognised in an Emissions Trading Scheme (ETS).

Background

This memo provides a brief overview of an IASB staff paper which was presented at the November 2009 IASB/FASB joint meeting. A copy of this paper is attached as Agenda paper 16.4.1.

At the meeting, the IASB and FASB discussed ‘Accounting for items in a voluntary [ETS] scheme’. IASB staff used the scenario of a voluntary (contractual) scheme as they consider it easier to analyse items to be accounted for, if those items arise from a contract (rather than legislation), because the contract provides an unambiguous anchor which establishes rights and obligations when the contract commences¹.

The mechanics of a voluntary scheme are as follows:

- members make a legally binding commitment to reduce emissions (compared to historic levels);
- members are committed for the length of a commitment period²; and
- once signed up, the scheme is no longer voluntary.

When an entity joins the scheme, they receive two items:

- membership in the scheme; and
- the right to receive an allocation of emissions allowances (specified amount).

In exchange for these two items, the member promises to pay one emissions allowance for each unit of emissions that occurs during the commitment period.

The purpose of the IASB staff paper 3A (see Agenda paper 16.4.1) was to determine which items meet the definition criteria in each of the IASB/FASB’s frameworks. The paper does not consider recognition, measurement or presentation issues (although the discussion at the meeting tended to stray into when a liability should be recognised).

¹ AASB staff do not consider there should be any difference in accounting for an ETS regardless of whether it is a statutory or voluntary scheme.

² A commitment period is typically split into annual compliance periods.

Although the paper analysed two items – ‘do the items received meet the asset definition’ and ‘do the membership obligations in a voluntary scheme meet the liability definition’, the main focus of the staff paper and therefore this memo concerns the liability definition.

The following example is provided as a basis for discussion:

On 1 January 2010, an entity becomes a member of a voluntary scheme with a one-year commitment period, starting on 1 January 2010. The entity is entitled to an allocation of 100 allowances. The allowances that result from the allocation are issued on 1 January 2010. In exchange for the membership in the scheme and the right to an allocation, the entity promises to pay one allowance for each unit of emissions occurring during the commitment period. The entity estimates it will emit 110 units of emissions during the commitment period. That means the entity expects that its demand for allowances will exceed its allocation of 100 allowances by 10 units. The entity plans to make up the expected shortfall by acquiring allowances on the market.

IASB staff provided two views of whether an obligation associated with membership in a voluntary scheme meets the liability definition in both frameworks.

View 1 – A member’s actual emissions create the obligating event. A member of a voluntary scheme does not incur a present obligation until it has emitted. Until emissions have occurred, the member can avoid the outflow of allowances by its future actions.

View 2 – The membership contract creates the obligating event. A member incurs a present obligation as a result of becoming a member of a scheme. As of signing the membership contract, the obligation to pay allowances is unconditional. Only the amount of allowances due under the membership contract is uncertain.

Each of the views is supported by guidance in existing IFRSs and FASB statements. View 1 is supported by IAS 37 *Provision, Contingent Liabilities and Contingent Assets* and FASB Statement No. 143 *Asset Retirement and Environmental Obligations*, whilst View 2 is supported by reference to IFRS 3 *Business Combinations* and FASB Statement No. 141(R) *Business Combinations*.

View 1 – IAS 37 paragraph 17 states:

“A past event that leads to a present obligation is called an *obligating event*. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

- (a) where the settlement of the obligation can be enforced by law; or
- (b) in the case of a *constructive obligation*, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.”

Further IAS 37 paragraph 19 states:

“It is only those obligations arising from past events existing independently of an entity’s future actions (that is, the future conduct of its business) that are recognised as provisions. ... Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised”.

Therefore, by applying the guidance in IAS 37, membership to a voluntary scheme does not meet the definition of a liability as there is no present obligation, because, even though they have been given emission allowances, they can take action not to emit and therefore will not have to surrender the allowances and are free to sell them into the market.

AASB staff comment: View 1 received some support from both IASB and FASB members and was considered to be consistent with both Frameworks and existing IFRSs and FAS Statements.

View 2 – IFRS 3 requires, that if an acquirer has an obligation to make payments to the former owner of the acquiree and those payments are contingent on a specified future event (contingent consideration) then the acquirer is to recognise that obligation as a liability (provided the item is not classified as equity).

Paragraph BC346 states:

“In developing the 2005 Exposure Draft, both boards concluded that the delayed recognition of contingent consideration in their previous standards on business combinations was unacceptable because it ignored that the acquirer’s agreement to make contingent payments is the obligating event in a business combination transaction. Although the amount of the future payments the acquirer will make is conditional on future events, the obligation to make them if the specified future events occur is unconditional. The same is true for a right to the return of previously transferred consideration if specified conditions are met. Failure to recognise that obligation or right at the acquisition date would not faithfully represent the economic consideration exchanged at that date. Thus, both boards concluded that obligations and rights associated with contingent consideration arrangements should be measured and recognised at their acquisition-date fair values.

Any uncertainty in the payment amount is reflected in measurement and not recognition.

Therefore IASB staff concluded that because an entity’s obligation to pay allowances are contingent on that entity’s future actions and that obligation is unconditional, using IFRS 3 by analogy, membership to a voluntary scheme meets the definition of a liability as there is a present obligation.

AASB staff comment: View 2 also received support from both Boards however, some members expressed that the analogy to IFRS 3 was tenuous and that they did not consider this view to be consistent with the Frameworks. Nevertheless, some members suggested that View 2 provided more useful information for users.

In summary:

Applying the guidance in IAS 37/Statement No. 143 an entity has a scheme liability on 1 January 2010 only if, and to the extent that, the entity has emitted on 1 January 2010.

Applying the guidance in IFRS 3/Statement No. 141(R) an entity has a liability on 1 January 2010 that reflects the promise to pay allowance throughout the commitment period. The entity estimates it will pay 110 allowances for the one-year commitment period. The liability exists irrespective of whether the entity has already emitted.

The Boards conducted an informal vote 10/4 (IASB) and 4/1 (FASB) in favour of view 2. A suggestion was provided by an IASB member which received support from some FASB members whereby the entity would estimate the liability or asset based on expected emissions less allowances and present this net position.

IASB staff noted that given their direction they will now have to justify how an entity could have an obligation for emissions prior to actually emitting.

AASB staff comment: AASB staff are of the opinion that it was the day one gains or losses which would occur under View 1 which resulted in the preference for View 2.

AASB staff view

AASB staff consider that under existing IFRS view 1 is the correct interpretation of when a liability should be recognised.

Attachments

Agenda paper 16.4.1 - IASB Staff Paper 3A November 2009 – Accounting for the items in a voluntary scheme.