Approaches to Recognition and Measurement of Emission Liabilities arising from Emission Trading Schemes

1 This paper is prepared to initiate the process for the deliberation of general purpose financial reporting issues that are expected to arise in the flexible phase of the carbon pricing mechanism (CPM). The process is initiated at this point in time mainly due to Australian Government's recent confirmation that the flexible phase of the CPM, initially planned to begin on 1 July 2015, would be brought forward by one year.

2 The recognition and measurement of emission liabilities would be a significant financial reporting issue facing Australian emitter entities under the flexible price phase of the CPM. The existence of divergent practices internationally would not help. Any Australian pronouncement would need to adhere to IFRSs including IFRIC Interpretations. However, the emergence of divergent practices in recognising and measuring emission liabilities may have created doubts as to the positions the IFRS Interpretations Committee and the IASB have taken in various interpretations regarding the recognition and measurement of liabilities under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Accordingly, it would be beneficial to have an AASB clarification on this matter including seeking confirmation from the IFRS Interpretations Committee that the previous positions taken by the Committee and the IASB in IFRIC Interpretations regarding this issue have not changed.

Purpose of this paper

3 This paper focusses on the application of IAS 37 in the recognition and measurement of emission liabilities by emitter entities. It sets out:

(a) relevant requirements of the (now withdrawn) IFRIC 3 *Emission Rights*;

(b) evidence of diverse practices that have emerged after the withdrawal of IFRIC 3 in recognising and measuring emission liabilities arising from emission trading schemes (ETSs);

(c) IFRS Interpretations Committee's views expressed in a number of interpretations in regard to application of IAS 37; and

(d) a staff recommendation to seek IFRS Interpretations Committee's confirmation of its view on the recognition and measurement of liabilities under IAS 37.

IFRIC 3 requirements

4 IFRIC 3 *Emission Rights* was issued in 2004 because emission control schemes that utilised marketable allowances (permits)[1] were becoming widespread as a result of the Kyoto Agreement and entities were looking for timely guidance. Of particular interest was the European Union Emissions Trading Scheme (EU ETS) that was to be launched in January 2005.

5 IFRIC 3 explained how to apply existing International Financial Reporting Standards (IFRSs) to a cap and trade ETS. IFRIC 3 stated that such a scheme gives rise to an asset for permits held, a government grant and a liability for the obligation to deliver permits equal to emissions that have been made to be accounted for as follows:

1 In this paper the terms 'allowances' and 'permits' are used interchangeably

(a) Permits, whether issued by government or purchased, are intangible assets that shall be accounted for in accordance with IAS 38 *Intangible Assets*. Permits that are issued for less than fair value shall be measured initially at their fair value.

(b) When permits are issued for less than fair value by government, the difference between the amount paid and fair value is a government grant that is within the scope of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. Initially the grant shall be recognised as deferred income in the balance sheet and subsequently recognised as income on a systematic basis over the compliance period for which the permits were issued, regardless of whether the permits are held or sold.

(c) As emissions are made, a liability is recognised for the obligation to deliver permits equal to emissions that have been made. This liability is a provision that is within the scope of IAS 37. It shall be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. This will usually be the present market price of the number of allowances required to cover emissions made up to the balance sheet date.

(d) The existence or requirements of an emission rights scheme may cause a reduction in the cash flows expected to be generated by certain assets. Such a reduction is an indication that those assets may be impaired and hence requires those assets to be tested for impairment in accordance with IAS 36 *Impairment of Assets*.

6 At its June 2005 meeting, the IASB considered the developments subsequent to the publication of IFRIC 3 within the European Union, including European concerns that IFRIC 3 would create measurement mismatches where some items are measured at cost (IAS 38 and IAS 20) and others at fair value (IAS 37) and reporting mismatches where some gains and losses are reported in profit or loss (IAS 37 and IAS 20) and other items in equity (IAS 38).

7 At that meeting, the IASB affirmed that IFRIC 3 was an appropriate interpretation of existing IFRSs for accounting for the EU Scheme. It noted that commentators had indicated that the markets for permits, despite developing rapidly, were thin and some European governments had yet to issue permits to companies. While acknowledging constituents' concerns, the IASB decided to withdraw IFRIC 3 in July 2005. The IASB chair at the time indicated that the Board did not want the issue to cloud the transition of Europe to IFRSs at that time, especially as the issue was not urgent then.

8 The withdrawal of IFRIC 3 in 2005 meant that under the hierarchy for selecting accounting policies in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, emitter entities have needed to adopt accounting practices that are consistent with IFRSs. Practices have evolved since in different jurisdictions.

Diverse practices developed

9 After the withdrawal of IFRIC 3 there is evidence that divergent practices have developed in relation to recognition and measurement of emission liabilities by emitters under ETSs. This diversity has mainly been in relation to accounting for

ETSs by European companies under Phases 1 and 2 of the EU ETS where issuance of free permits has been prevalent.

The ACCA Survey

10 A survey[2] of the Association of Chartered Certified Accountants (ACCA) of a sample of 26 emitter companies reported the following results:

(a) A significant number of companies made no disclosure in this area (six of the 26 companies, or 23% of the sample).

(b) Most companies (15 companies, or 58% of the sample) valued the obligation based on the carrying value (cost) of allowances already granted/purchased (which, in practice, tends to be zero), with the balance valued at the prevailing market price. Four companies followed a slightly amended version of this accounting practice, with emission allowances purchased under forward contract prices shown at the contract price.

11 The survey notes that these accounting practices were not permitted under (the now withdrawn) IFRIC 3. IFRIC 3 recommended that assets (permits) should be treated independently of liabilities, as follows:

(a) a liability should be recognised as emissions are made, and the liability should be categorised as a 'provision' and, hence, should be treated in accordance with IAS 37;

(b) the liability should be measured at the best estimate of the expenditure required to settle the present obligation at the reporting date, that is, the amount an entity would rationally pay to settle the obligation at the reporting date or to transfer it to a third party at that time (paragraphs 36 and 37 of IAS 37).

12 The ACCA survey notes that interviews provided further insights into why most companies have followed the mixed measurement (covered liability at cost, balance at market value) approach. As in the case of assets, "the absence of firm rules appears to have resulted in the adoption of the easiest accounting policy". Moreover, this accounting approach was favoured as it does not require full disclosure of assets and liabilities. The choice reflected here is, however, tied into the practice whereby governments have granted allowances at no charge in the early Phases (1 and 2) of the EU ETS. Effectively, measuring allowances 'at cost' means assigning them a nil value because they are not paid for. It follows that liabilities can therefore also be measured at cost (that is, at nil value).

13 The survey also reports that a third of the companies surveyed (eight of 26) are initially accounting for carbon assets at nil value on the rationale that permits are issued at no charge. Staff note this would arise when they depend upon one of the options in IAS 20 for this, despite IFRIC and the IASB conclusion that this was unacceptable when IFRIC 3 was issued. It should be noted that in Phase 3 of the EU ETS there is to be a shift towards EU allowances being paid for by companies. A large proportion of companies (58%) are valuing the obligation on the basis of the cost

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2 *Accounting for Carbon*, The Association of Chartered Certified Accountants (UK), 2010.

of allowances already granted/purchased, and measuring the balance of the liability at the market value, a practice that implies accounting only for their shortfall in allowances.

PwC/EITA Survey

14 The results of the PwC/EITA survey[3] also show that there is a range of valuation treatments being applied in valuing the emission obligations:

(a) Most respondents (47%) value the obligation based on the carrying value of allowances already granted (which may be nil) and purchased, and then value the balance if applicable at the prevailing market price of allowances.

(b) A further 26% apply an approach similar to (a) but value that element of the obligation hedged by forward purchases of allowances at the underlying forward contract price. This reflects a 'cost to the company' and is indicative of the expected cash flows to be incurred in order to settle the obligation.

(c) 16% of respondents simply apply the prevailing market price for the entire obligation, irrespective of how the company intends to settle it. This is akin to the approach set out in IFRIC 3 prior to its withdrawal.

IFRS Interpretations Committee's view on IAS 37 measurement requirements

15 Paragraph BC 3 of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* notes:

> "IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that the measurement of the liability, both initially and subsequently, should be the estimated expenditure required to settle the present obligation at the end of the reporting period and should reflect a current market-based discount rate. It requires provisions to be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. Hence, when the effect of a change in estimated outflows of resources embodying economic benefits and/or the discount rate is material, that change should be recognised."

16 Paragraph BC19 of IFRIC 1 affirms the measurement basis:

> "BC 19 In reaching its consensus, the IFRIC considered the US GAAP approach in Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations (SFAS 143). Under that standard, changes in estimated cash flows are capitalised as part of the cost of the asset and depreciated prospectively, but the decommissioning obligation is not required to be revised to reflect the effect of a change in the current market-assessed discount rate."

17 Paragraph BC20 of IFRIC 1 further notes that[4]:

> "BC 20 The treatment of changes in estimated cash flows required by this Interpretation is consistent with US GAAP, which the proposal in D2 was not. However, the IFRIC agreed that because IAS 37 requires a decommissioning obligation to reflect the effect of a change in the current market-based discount rate (see paragraph BC3) it was not possible to disregard changes in the discount rate. Furthermore, SFAS 143 did not treat changes in cash flows and discount rates in the same way, which the IFRIC had agreed was important."

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3 Trouble-Entry Accounting – Revisited, *Uncertainty in accounting for the EU Emissions Trading Scheme and Certified Emission Reductions*, PricewaterhouseCoopers (PwC) and International Emissions Trading Association (IETA), 2007.

4 References to D1 or D2 in the following paragraphs are references to related draft Interpretations that were published for comment prior to the issuance of relevant IFRIC.

18 Thus the IFRIC position on measuring a liability under IAS 37 is valuation at current market value and this position was adopted in IFRIC 3:

> 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'.
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> 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.

19 The 'mixed measurement approach' applied in practice is similar to the approach proposed by respondents to D1 (the draft IFRIC that was published for comment) which relies on an interpretation of the 'the best estimate' with which IFRIC disagreed. Proponents of that approach argued that, to the extent permits are held, the best estimate may be the carrying amount of permits and to the extent that emission exceeds permits held, the fair value of a permit (remeasured at each reporting date) may be the best estimate.

The notion of interdependency between asset and liability

20 Under IFRIC 3 the asset (permit) and the liability (obligation to surrender permits in respect of emissions made) exist independently. Paragraph BC12 states:

> "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."

21 Some, however, argued that there is an economic interdependency between the asset (permit) and emission liability. For example, in discussing the accounting mismatches created under IFRIC 3, European Financial Reporting Advisory Group (EFRAG) stated[5]:

> "These accounting mismatches are all the more critical because of the fact that there is an economic interdependency between the assets and liability involved in the scheme: emission rights are granted to allow entities to settle their liability for emissions made up to a specified level; emission rights are the only assets eligible for settlement of the liability for emissions made. Because of these mismatches EFRAG is of the opinion that the resulting financial information does not always faithfully reflect economic reality."

22 The idea of existence of interdependency between the asset (permit) and emission liability has underlined the development of some ETS accounting models that have been proposed in Europe after the withdrawal of IFRIC 3. This development will be considered next.

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5 EFRAG's Letter to the Director General of European Commission, May 2005, page 2. The letter was accessed on 12.8 2013 at http://www.iasplus.com/en/binary/efrag/0505ifric3endorsementadvice.pdf.

Recognition and Measurement of emission liabilities under recently proposed models

23 As noted above with the withdrawal of IFRIC 3, evidence shows that divergent practice ensued. More recently, variants of a model[6] have been proposed that distinguish between holding of permits (emission rights) for production /compliance purposes (such as those held by a manufacturing entity to be delivered in extinguishment of emission liability) and holding of permits for profit making purposes (such as those held by a trader). The proposals are made in the context of a cap and trade ETS.

Role of predetermined business models

24 The proponents of proposed models argue that accounting standards have provided for scenarios where methods applied in the recognition and /or measurement of assets are linked to the usage of the asset. Examples cited are IAS 2 *Inventories* and IAS 39 *Financial Instruments: Recognition and Measurement*. It is noted that IAS 2 provides for the inventories used in manufacturing activity to be measured at cost while the measurement of the same inventory would be at net fair value in the case of a broker. Paragraph 39.6 of IAS 39 is also invoked to argue that requirements for contracts to purchase at a fixed price would not classify such contracts as derivatives if they are physically settled for the company's own use. The 'usage' argument is then applied to 'permits' to create two business models, a 'production (compliance) model' and a 'trading model'.

25 Under a production model the purchase of permits is seen to be needed to comply with obligations towards Government. Permits are a specific commodity to be used in the production process and their purchase would 'freeze' an element of the production cost. It is the 'purchase' and not 'the surrender' of permits that is said to place the entity in compliance with emission obligations.

26 Under a production model, proponents argue, permits are recognised as 'inventory' and can be bought both before and after emissions occur, as long as they are made, but before the designated surrender date. Under a trading model, permits are acquired voluntarily with a view to generating gain. The trading activity is an activity separate from production activity. An entity might have production and/or trading activities.

27 To guard against opportunism, proponents argue that , an entity that adopts a production or trading model should be 'locked' into the chosen model unless the business model changes and should identify and justify the adopted model. Appropriate procedures should be put in place to segregate entity's production activities from trading activities in permits. The entity should document the strategy, targets and contracts to purchase permits to validate the business model adopted under ETS. If an entity buys and sells permits while adopting a production model, there should also be rules that would determine when it has deviated from the production model to an extent that would invalidate the production model.

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6 See for example, Accounting of GHG Emissions Rights Reflecting Companies' Business Models' by the French standard setter Autorite des Normes Comptables (ANC), May 2012 at http://www.efrag.org/files/EFRAG%20public%20letters/Emission%20Rights/ANC_Proposals_for_Accounting_of_Emission_Rights.pdf (accessed 1 August 2013). See also Emissions Trading Schemes, EFRAG, draft comment letter at http://www.efrag.org/files/Emissions%20Trading%20Schemes/Draft_Comment_Paper_on_Emissions_Trading_Schemes.pdf.

28 The business model approach does not take into account the flexibility that an ETS usually provides in buying, selling, banking and borrowing emission rights. It seems it caters for a predetermined strict production/compliance regime to enable linkage between permits and liability for measurement purposes and netting permits acquired with the liability incurred, on the balance sheet. As noted in paragraph 25 above, the proposed production model substitutes the 'obligation to purchase permits' for the 'obligation to surrender permits equal to the emissions made' as subscribed by IFRS Interpretations Committee.

Application of the notion of interdependency

29 Proponents of linkage between measurement of permits and emission liability argue that participating in an ETS as an emitter will lead to return of permits to settle the obligation under an ETS. It is contended that this linkage between permits and the obligation arising from an ETS is a specific feature of an ETS system that distinguishes permits from other assets and this necessitates specific guidance to account for assets and liabilities under an ETS.

30 The linkage argument in the recently proposed business model approach is not a new one and, as noted in paragraph 21 above, it is already the justification for applying a mixed measurement approach in recognising emission liabilities under existing practice. In fact the linkage argument in the context of both the existing practice and proposed models are rooted in regulating the EU ETS. The proponents of linkage argue that linking the measurement of the emission liability to the carrying amount of the permits held would reduce some accounting mismatches created under IFRIC 3 approach. Staff note that this could be an incentive to bifurcate the business model of an emitter into a production and a trading model. The effect of locking into a production model is to subscribe to a measurement process in a predetermined framework where the purchase of permits determines the value at which liability is recognised.

31 It should be noted that the business model approach noted above is likely being developed in Europe with a view to be made available as a proposal for IASB's further work on accounting for ETSs. The proposed model does not purport to be based on IFRSs as its premise is that permits do not fall within asset classifications under IFRSs.

Staff view and recommendation

32 Staff are of the view that, as previously required and clarified by the then IFRIC, and as approved by the IASB in IFRIC Interpretations, liabilities recognised under IAS 37, including emission liabilities, should be measured at a current value that complies with paragraphs 36 and 37 of IAS 37. In the case of ETSs, there is an active market in permits and the emission liability would need to be measured at market prices.

33 Staff are of the view that it would be important that the AASB clarifies its position in regard to measurement of liabilities under AASB 137 (IAS 37) as this would be instrumental in future discussions on various aspects of accounting for the flexible phase of the Australian CPM. Staff think it would be beneficial to seek confirmation from IFRS Interpretation Committee of the positions it has taken on this issue in IFRIC 1 and IFRIC 3 which also have had the IASB approval.

34 Staff are aware that IFRS Interpretations Committee has transferred the issue of accounting for ETSs to the IASB which has a planned research project to deal with it in a comprehensive way. The IASB deliberated the issues relating to accounting for ETSs in various meetings spanning over a three year period from December 2007 to November 2010 before deciding to initiate a research project on the subject. The proposed seeking of confirmation from the Committee is of a general and fundamental nature and in the context of existing GAAP, namely IAS 37. It should not be seen as an ETS-specific issue.