Issues paper – Accounting for Permits under Emission Trading Schemes

Purpose of this paper

1. This paper focuses on the treatment of permits by entities under Australian Accounting Standards. It sets out:

   (a) various arguments in regard to the classification of permits in the financial statements and whether free permits give rise to a liability;

   (b) provides evidence of diverse practices that have emerged after the withdrawal of IFRIC 3 *Emission Rights* in recognising and measuring permits acquired under emission trading schemes (ETSs); and

   (c) staff views in regard to the selected accounting issues considered.

Introduction

2. ETSs establish a market-based mechanism to regulate the production of emissions. They can be statutory, whereby participation in the scheme is mandatory; or non-statutory, whereby participation is voluntary.

3. There are essentially two main types of ETSs, known as 'cap and trade' schemes and 'baseline and credit' schemes. They differ in the manner they implement the market mechanism to regulate emissions.

4. Cap and trade schemes impose an overall cap on production of emissions during a commitment period, which may comprise several compliance years. To help ensure that emissions do not exceed the cap, the scheme administrator (regulator) provides permits up to the overall cap through auctions and other means, such as grants of free permits. Permits are usually provided at or shortly after the commencement of a compliance year and can be traded immediately.

5. Baseline and credit schemes assign baselines of emissions to specific emission sources (emitter entities). A baseline establishes the quantity of emissions that can be made by an emitter without incurring further costs. Under baseline and credit schemes, credits are issued to emitters that emit below their allocated baseline. They receive credits commensurate with the amount by which they have emitted below the baseline. The credits, therefore, cannot be issued until the entity's emissions for the compliance year are known, which is usually after the end of a compliance year. The credits can be sold on the market after that point in time and, if the scheme allows, may be banked for future use. That means, 'baselines' cannot be

traded; rather it is the 'credits' received by emitting below baselines that can be traded. Entities emitting above their allocated baselines would need to surrender credits, which they would need to buy on the market or use their own banked credits, if any.

6. Under a cap and trade scheme, permits equivalent to all emissions should be surrendered by liable entities while under the baseline schemes credits equivalent to emissions in excess of entities' baselines should be surrendered. Under both the cap and trade and baseline and credit ETSs, it is the market mechanism that determines the price of a permit or a credit at a level that acts as a disincentive to emit.

7. The flexible price phase of the carbon pricing mechanism (CPM) in Australia is regarded as a cap and trade ETS. The following discussion is in the context of such a scheme. A reference to ETSs is, therefore, a reference to cap and trade ETS.

Types of permits

8. Under the flexible price phase of the CPM, the following types of permits are envisaged:

   (a) permits that can be purchased in Government auctions;

   (b) permits that can be directly purchased from the Government at a fixed price. Fixed price permits would be sold by the Government in relation to a liability for the first three years of the flexible phase to act as a ceiling on the price of auctioned permits; and

   (c) permits that are received freely from the Government by entities conducting emission intensive trade exposed (EITE) activities under the Jobs and Competiveness Program and by highly emissions-intensive coal-fired electricity generators under Energy Security Fund.

9. As a cap and trade scheme, the flexible price phase of the CPM allows permits to be bought and sold on the market. Therefore, emitter entities that acquire permits to extinguish their emission liabilities, would also be able to trade them with a view to making a profit. Entities that specialise in trading permits, such as broker-traders, are also expected to be active in the market.

10. Purchased permits, whether acquired in an auction or purchased from the Government, would be indistinguishable from free permits received from the Government.

Nature of permits

11. Permits satisfy the definition of an asset in the AASB Conceptual Framework (the *Framework)*. The *Framework*, paragraph 49, defines an asset as follows:

> "An asset 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."

12. Permits are future economic benefits controlled by the emitter entity as a result of a past event – being the purchase or free receipt of the permits. In the flexible price phase of the CPM, the future economic benefits may flow to the emitter entity by:
    (a) using the permits to settle emission obligations in respect of an eligible compliance year; and
    (b) selling the permits on the market to other entities.

Classification of permits

13. Some argue that permits do not fit neatly under any existing accounting standard because there are multiple potential uses of the permits (for example, as a commodity, a currency and a financial instrument). Permits, it is argued, are hard to classify, they are a type of 'incommensurable'[1].

14. However, arguments exist as to the classification of permits under existing Australian Accounting Standards. Some of the arguments are discussed in the following.

Permits as intangible assets

15. Permits are intangible assets under AASB 138 *Intangible Assets* on the grounds that they are identifiable non-monetary assets without physical substance and exhibit features similar to licences and quotas because permits, it is argued by some, are rights to emit a specified quantity of CO2 equivalent. AASB 138, paragraph 44, lists airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources as examples of intangible assets.

16. There are both similarities and differences between permits and intangible assets such as quotas and licences, as noted in paragraphs 17-19 below.

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1 *Accounting for Carbon*, The Association of Chartered Certified Accountants (UK), 2010, page 20. – 'incommensurable' means lacking a common quality on which to make a comparison, (thefreedictionary.com)

17. In relation to the similarities, quota and licence mechanisms regulate access to a resource or activity. Like ETSs, quota mechanisms might impose an overall cap on the consumption of a restricted resource and quota shares are allocated to different consumers in relevant regulated market. Likewise, licence mechanisms regulate the number of market participants in a regulated market by allocating licences that grant access to a regulated market to licence holders (for example, a taxi licencing system that limits the number of taxis in operation). Licences and quotas may be transferrable separately or in conjunction with the related item such as a taxi or a ship.

18. In relation to the differences, quota and licence mechanisms do not generally allow engagement in a related activity or access to a related restricted source before allocation of the quota or licence. Although an entity would need a baseline allocation before emitting in a baseline credit scheme, in a cap and trade scheme, the entity can emit without having sufficient permits on hand to cover the emission. In particular, some argue that permits are essentially instruments that can be used to extinguish emission debts rather than being emission licenses or quotas. This is because for most licenses or quotas, the entity simply cannot undertake the activity to which the license or quota relates unless they are granted first. They note that under the flexible price phase of the CPM, an entity could operate and emit for a time, which could theoretically extend to the whole compliance year, without possessing permits.

19. Further in relation to differences, permits bought or received freely under an ETS can often be banked[2] for future use and under some schemes they can also be 'borrowed'[3]. In contrast, quotas and licences often have expiry dates[4] and cannot be carried forward for future use. However, there are some quota systems that do allow 'banking' quotas for future use or 'borrowing' future quotas for current use. For example, some fishing quota systems provide quota shares that are permanent and do not expire for the duration of the quota management system. Some fishing quotas are transferrable while others are not separate from a related asset such as a ship. The holder might also transfer the catch entitlement for a compliance

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2 Use of permits of a certain vintage year in the following years. A permit has a vintage year, which is a particular eligible compliance year.

3 Use of permits of future vintage years in the current year.

4 In Australia, Commonwealth commercial fishing permits can be granted for a maximum of five years. However, in most fisheries they are granted for one year at a time, and holders of those permits may apply to have them granted annually. See (http://www.afma.gov.au/services-for-industry/licensing-and-quota-management/statutory-fishing-rights-and-permits/) accessed 30.09.2013.

period separately without transferring the quota share. In some circumstances, catch entitlements can also be banked or borrowed[5].

20. Despite the similarities between permits and quotas or licences in some significant respects, the existence of differences in related mechanisms and the variety of ways quotas and licences operate arguably makes it difficult to classify permits as intangible assets on the ground of similarities with licences and quotas.

21. Staff note that there is; however, another argument to support treating permits as intangible assets. It may be argued that trading permits in a liquid market, whether by a broker-trader or an emitter entity, provides an opportunity for these entities to create cash inflows by controlling the permit. AASB 139 *Financial Instruments: Recognition and Measurement*, paragraph AG 10, refers to this characteristic that distinguishes financial assets from other assets such as intangible assets and inventories:

> "Physical assets (such as inventories, property, plant and equipment), leased assets, and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset."

22. The existence of a liquid market in permits under an ETS would provide the opportunity for the emitter entity and trader to make money. In such circumstances, permits could be argued to be an intangible asset for the emitter entity and a trading stock for the carbon broker[6].

23. Under the (now withdrawn) IFRIC 3, permits, whether granted by government or purchased, were to be treated as intangible assets accounted for in accordance with IAS 38 (AASB 138). Under that standard, there is a choice of the cost model or the revaluation model as the entity's accounting policy.

24. Staff are of the view that because trading permits in a liquid market provides an opportunity for both emitter entities and broker-traders to create cash inflows by controlling the permits, permits are rights that should be classified as intangible assets.

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5 For a discussion of quotas and licences, see for example, the draft Research Paper on Emission Trading Schemes presented to the IASB's May 2010 meeting.

6 AASB 138 does not apply to intangible assets held by an entity for sale in the ordinary course of business. The standard refers the reader for accounting for such intangible assets to AASB 102 *Inventories*, which states the standard does not apply to the measurement of inventories held by commodity broker-traders who measure their inventories at fair value less costs to sell and that such broker-traders recognise changes in fair value less costs to sell in profit or loss in the period of the change.

Permits as financial assets

25. Some argue that permits are similar to financial assets as they can be exchanged for cash in an active market or can be used as part of a contractual right[7] to receive cash from another party.

26. Proponents of treating permits as financial assets also argue that permits bought and sold by a broker-trader to make a profit are similar to financial assets held for trading. They argue that broker-traders hold permits with a view to making a profit in a market that experiences fluctuations in permit prices and therefore should classify permits as financial assets. These proponents also note that the treatment of permits as financial assets would be under a fair value model consistent with IFRS 9 *Financial Instruments*. They note this treatment is appropriate since the broker-trader's objective results in active buying and selling of permits and the entity is managing the instruments to realise fair value gains; rather than to collect 'contractual cash flows'.

27. Others argue that permits do not satisfy the definition of financial assets under financial instruments standards, as permits do not represent a right to receive cash (or other financial assets) from a third party and are not equity instruments. Also, they do not arise from a contract; rather they arise from participation in an ETS mandated by statute. They embody statutory not contractual rights.

28. The then IFRIC position on the classification of permits as financial assets was explained in IFRIC 3. Some respondents to the draft IFRIC preceding IFRIC 3 had disagreed with the IFRIC position that allowances (permits[8]) should be treated as intangible assets and had suggested that allowances should be accounted for as financial assets under IAS 39. Some also proposed that the allowance should then be treated as the hedging instrument of a forecast transaction (i.e. future emissions).

29. In response to the above view, IFRIC 3, paragraph BC 14 noted that:

    (a) 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.

    (b) 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.

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7 For example a forward contract to buy permits for 'non-own use'.
8 In this paper the terms 'permits' and 'allowances' are used interchangeably.

(c) 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'.)

(d) Being readily tradeable does not make allowances financial assets any more than, say, a readily tradeable commodity.

30. Nonetheless, paragraph BC16 of IFRIC 3 noted that the then IFRIC had 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 (e.g. a tonne of carbon dioxide).

31. It has also been noted that forward contracts on permits would, under certain conditions, be financial instruments. Entities must recognise them as derivatives and carry them at fair value, unless the 'own use' exemption under paragraphs 5 of IAS 39 applies. Under that paragraph, contracts that are entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements are exempt from the application of IAS 39.

32. Staff note that the treatment of permits as financial assets by analogy under the fixed price phase of the CPM was possible due to the particular characteristics of permits under that phase (which are different from the characteristics of permits under the flexible price phase of the CPM). The AASB staff paper on accounting for carbon tax by emitter entities[9] includes the following reasons to argue that permits in the fixed price phase of the CPM might meet the definition of a financial asset by analogy even though they fall outside the scope of AASB 132 and AASB 139 on the ground that their future economic benefits arise from statutory rights, rather than from a contractual arrangement with another party:

(a) permits, purchased or free, are offset against the entity's emission liability as if a currency;

(b) free permits embody a right to be cashed out with the Government; and

9 Staff paper: *Possible Financial Reporting Implications of the Fixed Price Phase of the Carbon Pricing Mechanism for Emitter Entities*, July 2012, updated April 2013. See AASB website, Quick links, Research Centre.

(c) purchased permits embody a right to be cashed out with the Government if there is a surplus of them at hand on final settlement.

33. Under the flexible price phase of the CPM, free permits cannot be cashed out with the Government and entities would not be refunded for their surplus purchased permits. Moreover, unlike the fixed price phase, the permits purchased are not automatically deemed to have been surrendered by emitter entities to meet their emission obligations. Under the fixed price phase the automatic surrender might be seen as the entity, in substance, paying for (all or part of) its interim emission liability as if in cash.

34. Based on the above analysis, staff are of the view that, under the flexible price phase of the CPM, there is not a strong case for treating permits as financial assets by analogy.

Permits as inventories

35. Some argue permits are required for compliance purposes and see them as an essential part of the production process. Accordingly, they note, permits are in the nature of consumables and should be treated as inventories[10].

36. Others argue that permits do not fall within the definition of inventories under AASB 102 *Inventories*. They note that although the entity's need for permits arises from emitting operations, permits are not physically consumed in such operations, as they do not have physical substance. Moreover, the entity can produce goods and services without first obtaining the permits.

37. Entities that have treated permits as inventories often use a layered cost approach to recognising their emission liabilities. Under this approach, the value of the emission obligation is based on the carrying value of permits already acquired and recognised as inventory and where allowances granted or purchased are insufficient, the balance of the liability is measured at the prevailing market price of permits. When permits held have been received free of charge, this approach, in practice, would mean that only the shortfall in allowances is recognised as a liability in the financial statements.

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10 The ACCA Survey (see footnote 1) notes that in the US the recommendation in the Federal Energy Regulatory Commission Uniform System of Accounts is that allowances should be classified as inventory, measured on a historical cost basis (that is, they should be valued at their original cost, in most cases zero), with recognition of costs as emissions are made (that is, as the allowances are 'consumed') on a weighted-average cost basis.

38. Treating permits as inventories has recently been contemplated by proposals in the context of European Union ETSs distinguishing between business models that deal with using permits in the production process and those dealing with permits as trading inventories.[11]

39. Inventories held by broker-traders who measure those inventories at fair value less costs to sell are not within the scope of AASB 102 in terms of measurement. These entities recognise the changes in fair value less costs to sell in profit or loss of the period.

40. Staff are of the view that the treatment of permits as inventories on the grounds that they are consumables used in the production process does not accord with the definition of inventories under AASB 102. The non-physical nature of permits and the fact that permits are not needed before producing goods and services arguably indicate that the choice of such a treatment might be more congruent to attempts to mitigate income statement volatility arising from fair valuing permits and emission liabilities; rather than being based on sound conceptual reasoning.

Current practice

41. 65% of respondents to the PwC/EITA survey[12] recognised granted allowances as intangible fixed assets on the balance sheet, whilst 15% recognised the granted allowances within inventory. The remainder applied alternative approaches that included 'other current assets', or not recognising them in the accounts at all.

42. In relation to purchased allowances, a clear majority (58% of respondents) recognised the purchased allowances as intangible assets. However, 11% recognised purchased allowances as inventory and 31% recognised them elsewhere on the balance sheet.

Staff view on the classification of permits

43. Staff are of the view that permits held by emitter entities under an ETS scheme:

    (a) do not meet the definition of a financial asset under AASB 132. They are neither contractual rights to receive cash or other financial assets, nor in the nature of equity instruments;

    (b) do not fall within the scope extension in AASB 139 for contracts to buy or sell a non-financial item, since they are not a contract to buy or sell a non-financial item; and

11 For a brief discussion of these models see agenda paper 12.2, September 2013 meeting, paragraphs 24-28.
12 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.

(c) are akin to intangible assets for the emitter entity and inventories held for sale by entities involved in trading permits.

44. Staff, however, note that forward contracts over permits may be treated as derivatives under certain conditions and accounted for in accordance with financial instruments standards. Under IAS 39, a contract to buy or sell a non-financial item (assuming permits are non-financial items) that can be settled net in cash or another financial instrument is treated as an executory contract and its accounting recognition would be postponed until the physical delivery takes place. However, if the forward contract is not for delivery of permits for 'own use', the fair value accounting model might be an appropriate approach to account for such contracts.

Question for the Board:
Does the Board have any comments on staff views expressed in paragraphs 43 and 44 above?

Free permits and corresponding credit entry

45. The recognition of free permits as an asset would lead to a number of questions such as:

(a) What would be the nature of the corresponding credit entry?

(b) Has the emitter entity incurred an obligation on the receipt of free permits?

(c) If the emitter entity has incurred an obligation on receipt of free permits, how is it going to be dealt with?

46. Some argue that the entity does not have a performance obligation on receipt of free permits. They note that the entity has received free permits to help it with its obligations arising from emissions and the grant of free permits will be tapered off until a time that no free permits would be granted. At that time, it is contended the entity would have put in place procedures to reduce emissions or would be ready to pay for them on the market.

47. Others argue that the 'no performance obligation' assumption would mean the free permits would need to be recognised as income in profit and loss as soon as received and this might not be a desired outcome. This group argues that free permits are granted to help the entity with the operations as it incurs additional costs under an ETS arising from emissions and therefore that free permits should not be taken to profit and loss until the cost creating activity (emission) occurs.

48. IFRIC 3 regarded free permits as '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 then IFRIC noted that the obligation imposed by an emission rights scheme to reduce emissions or deliver permits is a condition 'relating to the operating activities of the entity' and that the grant was intended to compensate for higher operating costs in the compliance period.

49. Under IFRIC 3, permits issued for less than fair value were to be measured initially at their fair value and the difference between the amount paid and fair value were to be a government grant falling within the scope of IAS 20 (AASB 120) *Accounting for Government Grants and Disclosure of Government Assistance*. Under that standard the grant would 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 granted. IFRIC 3 regarded recognising free permits and related deferred income at nominal amount (nil) under one of the options in IAS 20 as unacceptable. It noted that if this treatment were adopted, participants would not recognise permits issued free of charge on their balance sheet but they would recognise purchased allowances. The then 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. In accounting for free permits, not for-profit (NFP) entities would apply AASB 1004 *Contributions* and are not allowed to apply AASB 120. AASB 1004 would require free permits to be recognised at fair value with a credit to income.

50. With the withdrawal of IFRIC 3, there is evidence that divergent practice has developed in recognising free permits. The PwC/EITA survey notes that based on responses received, "the most common approach identified was to recognise the granted allowances at nil value". In fact, 76% of entities surveyed recognised free permits at nil value. Of the remaining 24%, 14% recognised free permits at fair value with the opposite entry recognised as deferred income and 10% at fair value with the opposite entry recognised immediately in the income statement.

Staff view on recognition of free permits

51. Staff are of the view that faithful representation of free permits as resources controlled by the entity would warrant their initial measurement at fair value. Recognising free permits at nil value would understate the value of assets held by the entity and would not allow users to

fully understand the financial performance of entities that have received free permits compared to those that have not.

52. Staff note a systematic recognition of deferred grant income commensurate with recognition of actual emissions as an expense would make the act of emission as the event that triggers income recognition rather than the free permit allocation. Recognising free permits at nil value would mean only the cost of carbon emissions beyond that represented by free permits would be reflected in profit and loss.

Free permits as conditional government grants

53. An alternative to the AASB 120 approach of recognising grants over the period in which a related cost occurs might be to apply the treatment of conditional government grants related to biological assets under AASB 141 *Agriculture* to free permits by analogy. Under AASB 141, a conditional government grant related to a biological asset is recognised as income when and only when the conditions attaching to the government grant are met. That would mean, until the conditions attaching to the government grant are met, a liability would need to be recognised under the *Framework* (rather than income) since the entity has a present obligation to satisfy the conditions arising from past events[13].

54. In relation to receipt of free permits, if they constitute a conditional government grant, that would mean the corresponding credit entry to the recognition of free permits as an asset would be a 'liability' (rather than 'income' which would be the case when grant of permits does not involve any conditions). The recognition of a liability would, for example, reflect the fact that permits should be returned to the Government if certain conditions are not satisfied. As noted in paragraph 48 above, the then IFRIC had considered that free permits involved as a condition the obligation imposed by an emission rights scheme to reduce emissions or deliver permits. If it can be established that a present obligation to satisfy the conditions attached to free permits exists then a liability would need to be recognised in relation to receipt of those permits and income from the grant of permits would be recognised on satisfaction of those conditions.

55. Whether the grant of permits is a conditional grant or not is controversial and there are various arguments and counterarguments in this regard. In 2010, the IASB considered the issue but its deliberations were not finalised. In the following, the issue of free permit as a

13 Paragraphs B63 and B72 of the Basis for IASC's Conclusions on IAS 41 *Agriculture*.

conditional grant is briefly considered from the narrow prism of an obligation to return free permits on closure of emitting operations as it might have relevance in the Australian context.

Free permits and closure of emitting operations

56. ETSs usually have provisions dealing with situations where the emitter entity ceases emitting operations part way through the compliance period. Of particular interest is whether entities that have received free permits under the scheme would need to return any permits to the regulator on closure of emitting operations.

57. ETSs often provide a definition of 'closure' and may differentiate between temporary and permanent closure. Where thresholds are involved in determining liable entities, they may also provide guidance as to how the closure would affect the determination of emission liability for the period the entity has been engaged in emitting operations. This in turn might affect the way free permits already granted are dealt with on closure, including whether there are any excess granted permits that should be returned. Excess permits represent permits that the government would have not granted, had it known of the closure of emitting operations beforehand.

58. Not all ETSs require the return of free permits on closure of emitting operations. In relation to the Australian CPM, the Clean Energy Regulations 2011 (amended 2012)[14] sets out rules relating to relinquishment of carbon units provided free to entities under the Jobs and Competitiveness Program. Under these regulations, free permits granted would be relinquished in the case of entity's closure or if a court orders relinquishment for other reasons.

59. An imminent Occasional Paper[15] intended to be issued by the AASB Research Centre shortly is expected to argue that the receipt of free permits imposes an unconditional obligation to return them if the entity exits the scheme and that the measurement of the liability should be based on the nature of this obligation. This would be the case only if the regulator requires the return of permits on exiting the scheme. Staff note this argument might be applicable to free permits received by eligible entities under the Australian Jobs and Competitiveness Program.

60. Staff are, however, aware that the issue of recognising a liability on receipt of free permits that reflects the obligation to return permits on closure of emitting operations might need to

14 Clean Energy Act, Section 146.

15 AASB Occasional Paper # 1, *Liabilities – the neglected element: a conceptual analysis of the financial reporting of liabilities*, Warren McGregor.

be dealt with within a broader conditional grant approach[16] that is envisaged as an alternative to the AASB 120 approach. Such an approach would also need to deal with the interaction of the liability arising on the receipt of free permits with that resulting from emissions.

Questions for the Board:

1 Does the Board have any comments on staff views expressed in paragraph 51and 52 above?

2. Does the Board think dealing with the receipt of free permits under a conditional grant approach, as an alternative to the AASB 120 approach, warrants further exploration by staff (see paragraphs 53-60)?

16 This broader approach would need to consider, for example, whether the grant of permits involves conditions, other than the return of permits on closure of emitting operations, that might result in a present obligation.