Agenda Item 11: Emissions Trading Schemes

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IPSASB Meeting

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Objective of this Session

- Provide direction on development of an Emissions Trading Schemes (ETSs) consultation paper.

Background

- March 2015—Decisions on four issues (CP structure, keep focus on ETSs, generic approach, key ETS factors)
- December 2014—IPSASB education session
- Task Based Group: Aracelly Mendez, Angela Ryan, Fabienne Colignon and Martin Koehler
- Collaboration with IASB:
  - IASB Staff—Jane Pike and Huaxin Xu
  - IASB meetings—Appendix A (November 2014 and January 2015)

Overview of Issues

1. Administrators—Alternative accounting approaches and their evaluation
2. Participants—Alternative accounting approaches and their evaluation
3. Accounting for:
   a) Impact of international agreements (e.g. Kyoto Protocol)
   b) Administrative agent's administering of an ETS (e.g. national government or government agency)

Background—ETS Administrator:

Step 1—Creates and issues *emission allowances* (EAs):

i. Establishes quantity and characteristics of EAs—Tradable rights to emit pollutants, e.g. 1,000 tonnes of greenhouse gases; EA market value=CA$15,000

ii. Cost of EA production is minimal (record in electronic register)

iii. Issues EAs at start of *compliance period*, by transfer (nil or subsidized cost), sale (e.g. auction) or both.

Step 2—Monitors *emissions* during compliance period

Step 3—Receives EAs back and cancels them:

i. End of compliance period--Receive EAs back from participants. (EAs cancelled as received.)

ii. Participants must submit sufficient EAs to cover emissions (If not, the Administrator applies penalties.)

Background—ETS Administrator: When do rights and obligations arise?

Administrator's rights and obligations (if any) would arise from:

i. *Start of compliance period*: Creation and issuance of EAs

ii. *During period*: Rights to receive EAs from participants (as they emit pollutants)

iii. *End of period:* Receipt of EAs from participants.

Key questions:

i. Do EAs that are issued for nil cost give rise to an *expense/liability* for the administrator? If so, how measured and what timing?

ii. Does *revenue* arise for the Administrator as participants surrender EAs (or as they incur obligations to surrender EAs). What is the timing of any revenue?

Issue 1 Administrators—Three Approaches:

- Approach 1, *Financial Liability*:
  - Treats EAs as similar to currency in circulation (financial liability for Administrator).
  - New Zealand Government uses this approach
- Approach 2, *Intangible Asset:*
  - Treats EAs as similar to permits (intangible assets).
  - Staff considers a viable alternative (not used)
- Approach 3, *Revenue*:
  - Recognize revenue if EAs are sold or payment received on transfer

Issue 1 Administrators—Identification of Approaches:

- Reviewed practice and any pronouncements:
  - New Zealand (Approach 1)
  - United Kingdom and Switzerland (Approach 3)
  - GFS reporting guidelines (*Split Asset approach*)
  - France–Standard 21 (CNOCP)
- Not many examples of accounting by administrators
- Only six ETSs where administrators apply accruals accounting (See Appendix C)
- *Staff view:* These three approaches cover the options, with Approach 3, *Revenue,* preferred in practice

Issue 1 Not an Alternative Approach—Split Asset

- *GFS reporting guideline:* EAs split into a financial asset and a "non-produced non-financial asset" (NPNF)
- Reasons to exclude:
  - NPNF part shows value changes in GFS supplementary statements, which are not used for financial accounting
  - Financial asset part "same" as Approach 3, *Revenue*
- Staff proposes that the CP:
  - Describe this approach and explain why it is not a proposed approach; and,
  - Discuss availability of information for GFS reporting (under each of the three approaches for consideration)

Issue 1 Administrators—Approaches 1 & 2

Event	Approach 1 Financial liability	Approach 2 Intangible asset
1. Create EAs	Measure at cost (inventory) (nil value)	Measure at cost (nil value) or market value (A1)
2. Issue EAs: **(a) Free** **(b) Market value**	Report liability (L1) and: (a) Expense at market value, or (b) Cash.	Report loss/gain from transfer/sale: (a) Loss/expense (b) Gain/revenue For (b) levy or tax revenue equal to gain on sale
3. Participants emit gases & incur obligation	Report revenue and asset (Ax), equal to participants' EA obligations.	Report revenue and asset (Ax) equal to participants' EA obligations.
4. EAs' market value fluctuates	Gains/losses as value of Ax changes.	Gains/losses as value of Ax changes.
5. Receive EAs back	Participants submit EAs to extinguish their EA accounts receivable. The currency related liability is extinguished.	At end of period the EAs replace Ax. (Ax then impaired to zero, since value of EAs is zero)

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Issue 1 Evaluative criteria applied to each approach:

a) Provides useful information on financial impact of *the phenomenon*;

b) Applies the *Conceptual Framework* (objectives, qualitative characteristics, constraints, elements and measurement);

c) Consistent with relevant IPSASs (apply directly or by analogy to this type of phenomenon);

d) Consistent with IASB developments and *provides scope to reduce unnecessary differences between GFS reporting guidelines and IPSASs*.

Action Requested

1. Indicate whether CP should include:
   a) All three approaches (Approach 1, *Financial Liability*, Approach 2, *Intangible Asset* and Approach 3, *Revenue)*;
   b) Any other approach; and
   c) The proposed evaluation criteria.

Issue 1 Administrators—Discussion of approaches

Approach 1, *Financial liability*—Issues:

- EAs may be transferred for nothing—unlike currency where value always received in exchange *(But EAs can be used to raise funds and share pollution costs.)*
- Does administrator have an obligation when EAs are issued—any need to transfer resources? *(But administrator is obliged to accept the EAs back, so there is a settlement "offset".)*
- Should participants' emissions result in revenue for the administrator?

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Issue 1 Administrators—Discussion of approaches

Approach 2, *Intangible Asset*—Issues:

- EAs become worthless when they are received back:
  - Are EAs really assets to the administrator? (Service potential, future economic benefits?)
  - Is the “right to receive an EA” valuable to the administrator?
- Should participants’ emissions result in revenue for the administrator?

Issue 1 Administrators—Discussion of approaches

Approach 3, *Revenue*—Issues:

- Narrow concept of the value of EAs—only to extent they generate cash. (No EA asset recognized. No EA liability.)
- But EAs are valuable to participants, so shouldn't they also be assets from the administrator's perspective? (Symmetry.)

Issue 1 Administrators—Discussion of approaches

Staff view: Support for Approach 3 because:

- Approaches 1 & 2:
  - Report elements that can be challenged from element definition perspective (*What are the future economic benefits?*)
  - Provide information on EA related assets and liabilities that:
    - May not be useful to GPFR users, and
    - May lack understandability.
- Approach 3 is a better representation of economic reality.
- *However,* Approach 3 focuses on cash generation, while Approaches 1 & 2 attempt to show value of EAs

Action Requested

2. Provide:
   - Views on the three approaches, (Approach 1, *Financial Liability*, Approach 2, *Intangible Asset* and Approach 3, *Revenue);* and
   - Reactions to staff support for Approach 3, *Revenue*

Background—ETS Participant:

Step 1—Receives *emission allowances* (EAs):

i. Tradable rights to emit pollutants
ii. Receipt may be through transfer (nil cost) or purchase

Step 2—*Emissions (obligation to submit EAs)*

i. Emissions occur—obligation to submit EAs
ii. Participants may buy or sell EAs during the period

Step 3—Submit sufficient EAs to cover emissions:

i. Participants must submit EAs or pay penalties

Issue 2 Participants—Four alternative accounting approaches

Four approaches identified:

a) Approach 1, *Gross–Liability (A)*
   i. EAs recognized at fair value (Defer revenue.)
   ii. Liability recognized as emissions occur. (EAs at MV)

b) Approach 2, *Gross–Liability (B)*
   i. As for Approach 1 (Same treatment of EAs. Same liability recognition timing.)
   ii. Liability measurement: Value of EAs held + MV for any shortfall in EAs

c) Approach 3, *Net:* EAs at cost. Shortfall liability at MV.

d) Approach 4, *Gross 1(A) Revenue on Transfer*

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Issue 2 Participants—Identification of these four accounting approaches

a) Same as four approaches for IASB's June discussion.

b) First three approaches common in practice and identified by IASB staff

c) Approach 4 proposed by IPSASB staff—has an IPSAS revenue recognition approach to transferred EAs.

d) IASB staff concerns about Approach 4:

   i. Not used in practice

   ii. Not supported in discussion at IASB sponsored joint meeting of Global Preparers Forum (GPF) and Capital Market Advisory Committee (CMAC)

Issue 2 Participants—More on Approach 1, *Gross–Liability (A)*

a) EAs recognized at fair value (whether a transfer or a purchase) e.g. Grant of 10,000 EAs at fair value of CU1,000/EA: Dr. EA Asset CU10 million

b) Defer revenue:

   i. First, recognize a liability ("revenue received in advance") equal to value of EAs

   ii. Then, recognize revenue on "systematic basis" (as emissions occur)

c) Liability (and expense) recognized as emissions occur:

   i. Obligation to submit EAs—to cover actual emissions

   ii. EAs measured at MV

Issue 2 Participants—More on Approach 4, *Gross 1(A) Revenue on Transfer*

Approach 4 is the same as Approach 1, except for revenue recognition:

a) Revenue from EA *transfer* --at nil cost

i. Revenue equals fair value of EAs

Example: Cr. Revenue CU10 million

i. No deferral of revenue; No recognition of "deferred revenue" liability

b) IPSAS 23 approach (No condition on transferred assets)

c) Little support from GPF and CMAC joint discussion

Issue 2 Participants—More on Approach 2, *Gross–Liability (B)*

Same as Approach 1, except for *measurement* of liability from emissions, which depends on EAs‘ carrying value

Example: 10,000 EAs needed to cover emissions. Carrying value of EAs held by entity is CU1,000/EA. Purchase price for more EAs is CU1,200/EA

(a) 10,000 EAs held. Liability = 10,000 X CU1,000 = **CU10 M**

(b) 8,000 EAs held. Entity has to purchase 2,000 EAs:

Held EAs: 8,000 X 1,000 = CU8 million

Other EAs: 2,000 X 1,200 = CU2.4 million

Total liability reported: **CU10.4 M**

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Issue 2 Participants—Approach 3, *Net*

a) Revenue: EAs received are measured at cost, which could be nil

b) Emissions liability: Equals the "shortfall" (difference between EAs held and number of EAs needed) :

  i. No obligation if entity holds sufficient EAs to cover emissions

  ii. Shortfall measured at market value (MV)

Previous example:

(b) Shortfall was 2,000 EAs. MV was CU1,200. Liability would be CU**2.4 million**

Issue 2 Evaluative criteria applied to each approach:

a) Provides useful information on financial impact of the phenomenon;

b) Applies the *Conceptual Framework* (objectives, qualitative characteristics, constraints, financial elements and measurement);

c) Consistent with relevant IPSASs (apply directly or by analogy to this type of phenomenon);

d) Consistent with IASB developments and provides scope to reduce unnecessary differences between GFS reporting guidelines and IPSASs.

Action Requested

3. Indicate whether CP should include:
   a) All four participant accounting approaches:
      i. Approach 1, *Gross–Liability (A)*
      ii. Approach 2, *Gross–Liability (B)*
      iii. Approach 3, *Net.*
      iv. Approach 4, *Gross 1(A)—Revenue on Transfer.*
   b) Any further accounting alternative(s); and
   c) The proposed evaluation criteria

Issue 2 Participants—Discussion of approaches

a) Revenue recognition (transferred EAs):

i. *Approaches 1 and 2:* Deferred revenue not consistent with IPSAS 23

ii. *Approach 3:* Measurement of transferred EAs at cost not consistent with IPSAS 23

iii. *Approach 4:* Revenue consistent with IPSAS 23

b) Liability from emissions:

i. *Approaches 1 and 4:* Emissions liability consistent with IPSAS 19, *Provisions and Contingencies*

ii. *Approaches 2 and 3:* Use "EAs held" to determine emission liability. Does this reflect the economic phenomenon?

Issue 2 Participants—Discussion: Economic phenomena—Together or apart?

a) Appear to be two economic phenomena:
   i. Emission allowances (EAs); and
   ii. Obligations to submit EAs

b) Treat as separate phenomena or combine?

c) Approaches 1 and 4 treat these as separate. Approaches 2 and 3 combine. (For liability measurement (Approach 2) or for liability recognition (Approach 3))

d) “Together” suggests a “shield” provided by the EAs. The shield protects against either market value variability (Approach 2) or a liability from emissions (Approach 3)

Issue 2 Participants—Discussion of approaches

Staff view: Support for Approach 4 because it:

- Avoids recognition of elements that do not meet the definition criteria in the Conceptual Framework (e.g. no liability for deferred revenue)
- Has a more coherent, Conceptual Framework consistent measurement approach (as opposed to Approach 2, which mixes historical cost with market value)
- Treats participants' receipt of EAs as separate from obligations arising from emissions ((as opposed to Approach 2, which mixes historical cost with market value)

Action Requested

4. Provide views on the four approaches, and any reaction to staff support for Approach 4.

Issue 3 International Agreements and Agents' Administration of an ETS

Two issues arose during development of agenda paper:

a) What obligations arise from international agreements (e.g. Kyoto Protocol)?

b) What should ETS "administrative agent" report (e.g. national government responsible for administering EU ETS)

Issue 3 International Agreements and Agents' Administration of an ETS

Scope: Staff recommends that CP *not* attempt to address:

a) General issue of obligations from international agreements

b) General issue of accounting by administrative agents:

   i. Covers wide group of situations (e.g. tax collection agency, social benefits payment agency, government loan agency

However, there are issues that CP could address.

Issue 3 International Agreements and Agents' Administration of an ETS

a) How to identify an ETS:

   i. Does this arrangement create an ETS—international treaty, legislation, regulation or contract?

b) How to identify a participant in an ETS:

   i. Does the ETS apply? (Target. Power to apply)

   ii. Note issues raised by international agreements. (When does an international treaty result in a liability?)

   iii. Do *not* try to provide solution.

c) How to identify ETS administrator or agent:

   i. Note issue of reporting in administrator's financial statements and agent's financial statements.

Issue 3 Accounting for International Agreements and Agents' Administration of an ETS

a) Staff recommends that CP discuss criteria that:

   (i) Indicate creation of an ETS; and

   (ii) Identify an entity's ETS involvement (as administrator, administrative agent or participant)

b) The discussion should include reference to:

   (i) International agreements (e.g. Kyoto Protocol); and

   (ii) EU Member States' responsibilities for administering the EU ETS.

Action Requested

5. Indicate whether the CP should discuss criteria that:

(i) Indicate creation of an ETS, and

(ii) Identify an entity's ETS involvement (as administrator, administrative agent or participant) with reference to:

a) International agreements (e.g. Kyoto Protocol); and
b) EU Member States' responsibilities for administering the EU ETS.

Next Steps

Staff and the TBG will:

- Draft Consultation Paper (CP); and
- Provide draft CP and issues paper to IPSASB's September 2015 meeting.