



**Emission Allowances
Board Meeting Handout
February 21, 2007**

PURPOSE

The purpose of this Board meeting is for the Board to decide whether to add a project to its agenda to provide guidance for the accounting for emission trading programs.

BACKGROUND

Emission trading programs for the reduction of greenhouse gases have expanded globally in recent years, including at the international, national, and state levels. Cap and trade programs are a common emission trading approach. In cap and trade programs, a government (or government agency) typically issues rights (allowances) to participating entities to emit a specified level of emissions (pollutants). Participants in the program can choose to buy and sell allowances with others. At the end of a compliance period, participants are required to deliver allowances equal to their actual emissions or pay a fine. Market programs that are gaining prominence are based on reducing greenhouse gases by producing electricity from renewable energy sources and measuring compliance through renewable energy credits (RECs).

In a cap and trade program, each individual emission allowance has a vintage year designation (that is, the year an allowance may be used). Emission allowances with the same vintage year designation are fungible and can be used by any party to satisfy pollution from any source. Vintage year swaps are common among participants in a U.S. cap and trade program. In a vintage year exchange, a company with a current allowance shortfall exchanges allowances with a later vintage year designation for allowances with a current designation with an entity that has an opposite exposure.

Brokers and other nonparticipants typically buy and sell emission allowances in secondary markets. The secondary market for emission allowances is quite vibrant. Many believe worldwide markets will continue to develop for the trading of emission allowances.

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

CURRENT ACCOUNTING

The guidance contained in the Federal Energy Regulatory Commission's (FERC) Uniform System of Accounts is the only accounting guidance available in the United States that explicitly addresses emission allowances. Based on research efforts, the FASB staff believes that most companies generally account for emission allowances similar to FERC regulations. FERC requires companies to recognize emission allowances on an historical cost basis. The FASB staff is aware of diversity in practice, however, as some companies follow an intangible asset model for emission allowances. No authoritative guidance addresses the accounting for RECs.

EITF CONSIDERATION

EITF Issue No. 03-14, "Participants' Accounting for Emissions Allowances under a 'Cap and Trade' Program," attempted to address emission allowances by providing a comprehensive accounting model for participants in a cap and trade emission reduction program and alternative views for classification. After one EITF meeting, the Task Force decided to remove Issue 03-14 from its agenda. Some Task Force members observed that it had implications beyond cap and trade emission programs and they did not perceive a practice issue or diversity in the accounting for emission allowances.

TA&I COMMITTEE CONSIDERATION

After FASB Statement No. 153, *Exchanges of Nonmonetary Assets*, was issued in December 2004, questions arose in practice related to its scope and, specifically, whether exchanges of emission allowances (vintage year swaps) should be accounted for at fair value or carryover basis. The TA&I Committee approved a recommendation for the Board to add a project to its agenda to address the nature of emission allowances and clarify the accounting for vintage year swaps of emission allowances by participants in emission trading schemes. The staff exposed a draft proposed FSP for external review that stated that emission allowances were not inventory. Reviewers of the draft proposed FSP believed emission allowances should be addressed comprehensively. The reviewers commented that in the absence of a comprehensive model, the guidance should state what emission allowances **are** rather than what emission allowances **are not**.

INTERNATIONAL ACCOUNTING FOR EMISSION ALLOWANCES

IFRIC 3, *Emission Rights*, attempted to address how participants account for cap and trade emission trading schemes. IFRIC 3 stated that allowances are intangible assets and should be measured at fair value when received from the government. The grant is recognized in income on a systematic basis over the compliance period. At its June 2005 meeting, the IASB voted to withdraw IFRIC 3 in light of the reduced urgency for an interpretation and the requests from IFRIC to amend IASB standards. At its September 2005 meeting, the IASB decided to add a project to its agenda to provide a comprehensive model for emission allowances similar to issues discussed in IFRIC 3.

ISSUES TO ADDRESS AND QUESTIONS FOR THE BOARD

Issue 1: Does the Board wish to issue guidance on the accounting for emission allowances by participants in emission trading programs?

Alternative A—Issue limited guidance to define the characteristics of emission allowances (that is, the nature of the asset).

Alternative B—Issue comprehensive guidance on the accounting for emission allowances and emission trading programs, including asset recognition, measurement and impairment, revenue recognition, cost allocation, liability recognition, presentation, and disclosures.

Alternative C—Do not issue guidance on the accounting for emission allowances at this time.

The nature or characterization of emission allowances determines many aspects of the accounting model for emission trading programs, including carrying value, revenue recognition, and expense recognition. Proponents of Alternative A believe the issuance of authoritative guidance describing the character of emission allowances will address these issues. Guidance on the nature of emission allowances would eliminate diversity in practice and improve comparability of financial statements.

Proponents of Alternative B believe significant diversity in accounting for emission allowances is only eliminated if all aspects of emission trading programs are addressed. The following issues might need to be addressed in a comprehensive model:

1. Initial measurement and recognition
2. Gain recognition and deferral
3. Impact of the reporting entity's intended use
4. Measurement and recognition of purchased allowances
5. Related parties
6. Impairment
7. Expense recognition and costing methods
8. Classification
9. Presentation
10. Disclosures
11. Liability recognition and measurement.

Proponents of Alternative C believe that principles-based standards to be issued as a result of major projects, such as Phase 2 of Fair Value Option, Financial Statement Presentation, Revenue Recognition, and Conceptual Framework, may address aspects of emission allowances and related trading activities. Therefore, it may be inefficient to issue specialized accounting guidance that may change depending on subsequent decisions reached in other projects. Some proponents of Alternative C also believe guidance issued by the FASB could create convergence issues that might need to be addressed in the future when the IASB resumes work on its emissions project.

Staff Recommendation

The staff recommends Alternative B.

Issue 2: Does the Board wish to include the accounting for emission allowances by traders (that is, market-makers) within the scope of the project

Diversity in practice exists about whether emission allowances held for trading purposes should be accounted for at fair value by traders of allowances. Some base this view on guidance in the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, which they interpret as emission allowances being part of the trading inventory that is held for sale to customers in connection with market-making activities.

At the November 2006 EITF meeting, the Task Force discussed EITF Issue No. 06-12, “Accounting for Physical Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*.” The Task Force recommended that the Board consider addressing the accounting for traded physical commodity inventory in an FASB Staff Position (FSP). The Task Force will consider whether to address the scope of the Guide once the Board has made its decision on the FSP. Any decisions reached about physical commodity trading inventory could affect emission allowances.

Staff Recommendation

The staff believes that the accounting for emission allowances by traders also should be addressed. However, there are unique and distinct issues for traders and participants. The staff recommends that any guidance that addresses traders should be coordinated closely with other **potential** projects such as accounting for traded physical commodity inventory, Phase 2 of Fair Value Option, and/or Issue 06-12.