

MINUTES



Financial Accounting
Standards Board

To: FASB Board Members

From: Emissions Trading Schemes Team
(Vaheb x298, Sperry x445)

Subject: Minutes of the October 21, 2008 Joint Board Meeting: Emissions Trading Schemes **Date:** October 24, 2008

cc: FASB: Golden, Stoklosa, Bielstein, Vaheb, Mechanick, Gabriele, Posta, Klimek, Allen, C. Smith, Glotzer, Bhavé, Wilkins, Intranet; GASB: Galloway; IASB: Leisenring, Starbatty, Wilson, Upton, Clark, Rees

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic: Emissions Trading Schemes

Basis for Discussion: Agenda Papers 9, 9A, 9B and 9C

Length of Discussion: 11:45 a.m. to 12:45 p.m.

Attendance:

Board members present:	FASB: Herz, Linsmeier, Seidman, Siegel, and Smith
	IASB: Tweedie, Barth, Cooper, Danjou, Engstrom, Garnett, Gelard, Jones, Leisenring, McGregor, Smith, Yamada, and Zhang
Board members participating by phone:	None
Board members absent:	None

Staff in charge of topic:

FASB: Elsbree (by phone)

IASB: Starbatty

Other staff at Board table:

FASB: Golden, Stoklosa, Vaheb, and Sperry

IASB: Clark and Teixeira

Summary of Decisions Reached:

1. The Boards discussed accounting for emissions trading schemes, particularly how to account for the receipt of allowances in a cap and trade scheme and the baseline in a baseline and credit scheme. The session was educational and no decisions were made.

Objective of Meeting:

2. The objectives of this meeting were to have the Boards discuss the main accounting issues at the inceptions of emissions related cap and trade schemes, baseline and credit schemes, and to direct the staff in preparation for a decision-making meeting. The objectives were met.

Matters Discussed and Decisions Reached:

3. Mr. Starbatty began by clarifying to the Boards that the objective of the session was to be educational and to discuss the main issues arising at the inception of cap and trade and baseline and credit schemes in preparation for a decision-making meeting at a later date.

Issue 1—Are Credits and Emission Allowances Assets

4. Mr. Starbatty directed the Boards to slide 2 of the presentation, which compared certain characteristics of a typical cap and trade and a typical baseline and credit scheme. Under a baseline and credit scheme, an entity receives a baseline of emissions that it cannot trade. Credits are issued at the end of the compliance period only if emissions were below the baseline at the end of the compliance period. If its emissions are above the baseline, the entity surrenders the credits necessary to meet the regulatory requirements. Credits can be traded or ‘banked’ (see below for discussion of banking credits).
5. Under a cap and trade scheme, an entity receives a number of emission allowances that are tradable. At the end of the compliance period the entity is required to remit to the

regulator a number of allowances to offset its emissions during the period. The entity may freely trade the allowances during the period.

6. The timing of allowances being issued has different implications for the trading window under each scheme. The trading window for a baseline and credit scheme was much shorter and the number of allowances much smaller. Mr. Starbatty said both schemes allowed for a ‘banking’ of emissions allowances/credits, that is, they can be carried forward for use in a future compliance period. The trading windows are also effectively extended as one looks out over several compliance periods.
7. Mr. Starbatty explained that under both schemes, when an entity surrenders emission allowances/credits they are deleted from the electronic registry. If an entity does not have enough emission allowances/credits to cover its emissions, under some jurisdictions (such as the EU), the entity is required to pay a fine. Additionally, it has to make up for the shortfall by delivering emission allowances/credits in the following compliance period. Mr. Smith commented that in that case, entities are economically compelled to buy the credits/allowances.
8. Mr. Starbatty explained that the allowances or credits provide for future economic benefits since an entity could use allowances or credits to offset obligations. The more contentious issue is when an entity should recognize the credits or allowances. Mr. Starbatty explained that future installments are generally determined several years in advance by the scheme administrator and raise the question of whether an entity should recognize the right to receive allowances or credits as an asset.

Issue 1—Board Comments

9. Mr. McGregor asked if the authorities have discretion to withhold the scheduled allowance allocations. Mr. Starbatty said that generally the intention of a scheme was to give entrants a degree of certainty of allowance allocation. They need to know that the number of allowances they will receive in the future will remain constant. In other words, there was a high degree of certainty that the entity would receive the allowances. Mr. Garnett asked whether the entity would keep the allowances if it closed operations. Mr. Starbatty said that, if an entity closed down a plant or reduced production, in most schemes free allowances would no longer be issued to the entity in subsequent periods,

but that return of the current allocation may not be mandated by the scheme administrator.

10. Mr. Yamada asked about the basis for allocation of allowances in any one period. Mr. Starbatty said that allocation varied from scheme to scheme but the intention generally was that participants received allowances that were roughly equal to a past level of emissions with the intent of effecting a lower level of emissions. For example, a utility may be allocated allowances in 2008 equal to its level of emissions in 2000. Many European utilities, he added, publish the number of allowances they expect to receive in the future.
11. Mr. Starbatty stated that most large emitters trade allowances during the regulatory period. The emitters told the staff during its research that they saw trading emissions as a core competency so they would continue to do it. Mr. Starbatty said that he could not say that all entities generally traded emissions since the staff had only spoken with a few large emitters within the EU regulatory scheme.
12. He added that in the EU ETS, entities are also able to partially offset their obligations with CERs (Certified Emissions Reductions) that are obtained outside of the EU ETS but can be used within the EU ETS to satisfy the obligation to remit allowances. CERs are created in accordance with the project-based mechanism within the UN Kyoto Protocol. Entities exchange emission allowances against CERs, as the latter trade for less. Entities would argue that these exchanges represent an attempt to optimize their cost structure, rather than a pure trading activity. Mr. Elsbree added that the liquidity of the trading market varied from scheme to scheme.

Issue 2—In a Baseline and Credit Scheme, Is a Baseline an Asset

13. Mr. Starbatty discussed the baseline and credit scheme and raised the question of whether a baseline would be considered an asset. The baseline allowed entities to emit up to a limit without incurring incremental costs, he said. There were two views on this point: one was that a baseline was an asset; and the other was that it depended on the type of scheme. In a closed scheme, only a limited number of participants have access to the baseline.

Issue 2—Board Comments

14. Mr. McGregor asked which type of scheme (open or closed) was more prevalent. Mr. Starbatty stated that most EU schemes were open schemes, but some in the U.S. (such as the acid rain program) were closed, so only entities that had emitted in the past were entitled to receive credits.
15. Mr. Linsmeier said the slides only considered one portion of the definition of an asset—probable future economic benefits—and had not considered current or present rights. He continued that it would be helpful to him to consider both aspects of the definition. Mr. Gélard said the issue of a present right was important. He did not see why one would think there was no present right to an allocation.
16. Mr. Leisenring added that he would like to compare this baseline discussion with the Board’s discussion of whether general business risks are liabilities. He compared receiving a baseline to locating a factory in a tax-free jurisdiction and said that recognizing an asset in the latter circumstance because an entity is not required to pay taxes would not be appropriate.
17. Mr. Clark said he was not convinced that an open scheme would not lead to an asset. New entrants receive their own baseline, not that of another party. He thought there was a scarce economic resource there.
18. Mr. Gélard agreed with Mr. Linsmeier’s point that the question of a present right is important. Mr. Linsmeier noted that the issue is not just about the current baseline. If the focus is not limited to present rights, one would have to consider setting up assets for future years’ baselines. Mr. Leisenring said he would question whether the current baseline was an asset; Ms. Barth agreed.
19. Mr. Clark said as far as future installments were concerned, his view was that an entity recognizes its right to receive future installments if it does certain things. It was similar to an option and may be recognized as such.
20. Mr. Gélard felt accounting for a baseline was a question of recognition rather than the asset definition. He continued that if an entity purchased another entity with this right (a

baseline), the acquirer would recognize the baseline as part of the purchase price allocation.

21. Mr. Linsmeier stated that an acquirer would factor in the baseline to determine what amount it is willing to pay in a business combination, but he is not certain that the baseline would be separately recognized. Mr. Leisenring noted that if an entity had a choice to buy one plant in a taxed jurisdiction or another plant in a tax-free jurisdiction, all other things being equal, the buyer is likely to want to buy the tax-free plant, but that tax-free status would not be an asset.
22. Leslie Seidman said it used to cost nothing to emit because there was no regulatory scheme. The governments are now saying that it was still free up to a certain level as long as an entity has permission to emit, in the appropriate form and for the relevant time period. She would argue that an entity has no liability until it emits and noted that the same argument could be made on the asset side, that an entity does not have an asset until it emits. She stated that this analysis seemed straightforward; however, she added that the fact that allowances are tradable complicates this analysis.

Issue 3—Should an Entity Recognize a Baseline

23. Mr. Starbatty indicated that if one assumes that a baseline meets the definition of an asset, the next question was whether it could be measured reliably and therefore should be recognized as a separate asset. Again, there were two views: (1) no asset should be recognized and a baseline becomes an integral part of the emitting source; and (2) a separate asset should be recognized.

Issue 3—Board Comments

24. Mr. Garnett said that in the case of business combinations, some baseline valuations were attached to the emitting assets, presumably because they are linked to cash flows. So in many cases it was view (1) that was being used for the baseline. He asked whether the staff had come across situations where the baseline was viewed as a separate asset.
25. Mr. Starbatty said there was diversity in practice. He analogized to a license to operate a power plant, which under IFRS 3 and FAS 141R would be recognized as a separate asset. Mr. Golden indicated that in the U.S. there is a regulatory accounting requirement that

allowed for recognition of allowances as inventory. Mr. Elsbree said that the staff was not aware of a particular instance in which a *baseline* was separately recorded as an asset in a business combination, but that the staff was aware of *allowances* being recognized in a business combination.

26. Ms. Barth said that if a baseline were an asset, and she was not convinced that it was, the basis for valuing a baseline would be the cash flows that an entity avoids by having it. Mr. Starbatty said the view was that forward and future markets allow people to estimate cash flows. Mr. Elsbree stated that in some schemes entities are required to pay a penalty if they remit an insufficient number of credits or allowances, and in other schemes entities must remit a credit or allowance and that there is no option to pay a fine rather than remitting the credit or allowance. In the latter circumstance, it would be difficult to determine the cash flows that an entity avoids by having a baseline.

Issue 4—When Does an Entity Incur an Obligation

27. Mr. Starbatty introduced the topic of when a liability would be recognized. Under a cap and trade scheme, the present obligation occurred when the emissions occurred. Under a baseline and credit scheme there were two views: (1) that the obligation occurred only when emissions exceed the baseline; and (2) that expenses are recognized on a pro rata basis if the entity expects to exceed the baseline (assuming that a baseline is not recognized as an asset).

Issue 4—Board Comments

28. Mr. Gélard said the view that an entity would recognize a liability only when emissions were in excess of the baseline sounded like a mismatch. He questioned why an entity would not have a liability until after it exceeded its limit. Mr. Leisenring said he would compare this issue to the discussion the Board had in the Conceptual Framework project about when a law requires an entity to refill a hole only once the hole exceeds ten meters deep. The example in that discussion addressed whether a liability exists when the hole is only one meter deep.
29. Mr. Starbatty explained that the thinking of view 2 is that the liability for emitting over the baseline is not incurred only after emissions exceed the allocated baseline; rather, it is

incurred as the entity emits over the regulatory period (e.g., not just in the third and fourth quarters after the baseline is exceeded, but during the whole year as emissions are generated at a greater rate than the allocated baseline allows).

30. Mr. Linsmeier and Mr. Leisenring stated their view that an entity should not recognize a liability until there is a present obligation (that is, until emissions are in excess of the allocated baseline). Mr. McGregor suggested that the staff also consider the Boards' previous discussions of restructuring provisions and provisions for repairs and maintenance.
31. Mr. Linsmeier asked the staff what would happen if an entity were given allowances under a cap and trade scheme at the beginning of the financial year and it then shut down the plant. Mr. Starbatty said staff believed that under the majority of the national allocation plans in the EU ETS, the entity would not have to return the allowances.
32. Mr. Cooper felt the discussion so far had been built around a hypothetical situation and would not be representative of the economics of the schemes. He was concerned that different accounting could arise in different types of schemes, noting that one of the Agenda Papers described a scheme with allowances allocated 30 years in advance, in contrast to schemes with annual allocations. He did not see why there should be wildly different accounting results for these two different types of schemes. Mr. Leisenring said that different accounting results already exist if an entity has one plant in Detroit and another in Ontario, because the two countries have different schemes. Mr. Cooper said the question was whether a shareholder was better off investing in an entity that is subject to a scheme and therefore holds allowances. He did not think they were. Mr. Leisenring thought they were. Mr. Elsbree said that as far as the entities' management was concerned, being subject to an emissions scheme was a net cost and not a net benefit.
33. Mr. Smith felt that the allocation created a performance obligation. Mr. Linsmeier clarified that many jurisdictions do not include a performance obligation because the allowances may be kept by an entity if it shuts down without emitting.
34. Mr. Tweedie felt that an allocation of allowances was more like a performance-related government grant. An entity may be able to value the allowances but should only be allowed to recognize a gain if it fulfills the condition not to emit in excess of the cap. It

was not a gain because it was conditional. The objective of the scheme was to give an entity a gain if it did not emit as much. To recognize that gain upfront would be inappropriate. Mr. McGregor felt that the question for the Boards to debate will be whether a grant creates a performance obligation.

35. Mr. Siegel asked if some entities offset assets and liabilities under emissions trading schemes on the balance sheet. Mr. Starbatty said most European emitters recognize allowances at nil and recognize a liability only if they exceeded the allowances held, so there was offsetting in that sense.

Issue 5—Do the Schemes Require Consistent Accounting Models

36. Mr. Starbatty raised the question of whether the different types of schemes (that is, cap and trade versus baseline and credit) should have identical accounting models. He indicated that the differing schemes are designed to achieve identical targets. He also stated that the economics and net costs under both types of schemes would be identical if allocated allowances in a cap and trade scheme were equal to the allocated baseline in a baseline and credit scheme.

Issue 5—Board Comments

37. Ms. Barth said it was important if two schemes had the same rights and obligations, that they should be accounted for in the same way. She did not support accounting for different things in the same way. Mr. Zhang asked if the project would only cover these two types of schemes or if there were others to consider. Mr. Starbatty said there were other schemes in practice that were similar to cap and trade and they would be discussed as part of the scope. The basic focus, though, was schemes with tradable instruments, and the question for the Board was whether the scope of the project covers only emissions-related trading schemes.

Issue 6—Future Board Meetings

38. Mr. Elsbree said one of the things the staff wanted was a sense of direction in presenting the project to the Boards at future meetings. He asked the Boards whether they wanted the next session to focus only on the day one recognition question, or if they would rather have a more comprehensive paper that also covered offsetting and other issues.

Issue 6—Board Comments

39. The Board expressed a preference for the latter.

Follow-up Items:

None.

General Announcements:

None.