Cap and Trade Program

Extract, IFRS Discussion Group Report on the Meeting – May 30, 2017

Many governments around the world have, or are in the process of developing, programs to encourage corporations and individuals to reduce emissions of pollutants. The Government of Ontario introduced a Cap and Trade program as of January 1, 2017 whereby participants are allocated emission rights or allowances equal to a maximum level of allowable emissions. Entities are permitted to trade those allowances.

Below is a brief overview of Ontario's Cap and Trade program:

- The program introduces caps on the amount of greenhouse gas emissions that Ontario's largest polluters may emit, with the cap being lowered over time. Mandatory participants include large final emitters and specified larger natural gas distributers, fuel suppliers, and electricity importers. Voluntary participants may also partake in the program.
- Participants must submit allowances or credits equal to actual emissions for each compliance period. If the emissions exceed the cap, the participant must buy allowances or credits for compliance purposes. Excess allowances and credits can be sold into the market.
- The cap is the maximum number of allowances that the government creates each year. Capped participants can get allowances either through government grants, at a government auction or purchasing from other participants in a secondary market.
- Credits are compliance instruments granted for early reductions or for reductions, removals, or avoidance of carbon dioxide equivalent emissions achieved by those who are not capped participants.
- The program is expected to link with programs in Quebec and California to enable trading of allowances and credits among the three jurisdictions.

To date, there is no specific guidance under IFRS Standards for cap and trade programs. In 2004, the IASB had issued IFRIC 3 *Emission Rights* but due to various concerns, it was withdrawn in 2005. Absent specific guidance, entities have adopted various accounting approaches. The Group discussed three common approaches seen in practice in accounting for transactions arising from cap and trade programs.

Approach 1 – Apply an IFRIC 3 approach.

Cap and trade allowances (i.e., purchased or allocated) are recorded as intangible assets and accounted under IAS 38 *Intangible Assets*. Allocated allowances received are considered government grants and accounted at fair value under the IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* model. The grant is recognized as deferred income and recognized into income on a systematic basis over the compliance period. Purchased allowances are initially measured at cost. If there is an active market, the purchased allowances can be subsequently remeasured at fair value if the entity chooses to apply to the revaluation model in IAS 38. Otherwise, the purchased allowances are carried at cost, subject to impairment if indicators exist.

A liability for the obligation to deliver allowances equal to the emissions produced is accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The liability is measured at the best estimate of the expenditure required to settle the present obligation at the reporting date. This best estimate would usually be at the present market price of the number of allowances required to cover emissions made up to the reporting date.

Approach 2 – Apply net liability approaches.

The asset side of the transaction is similar to Approach 1 except that allocated allowances received are considered non-monetary grants under IAS 20, and therefore, recorded at nominal amount. There are two sub-approaches to consider for the liability side:

- *Net Liability Approach*: IAS 37 requires a provision to be recorded only if there is a present obligation as a result of a past event. Therefore, a provision is recognized when the actual emissions exceed the emission rights granted and held because in this situation, an entity would be required to purchase additional allowances in the market or incur a penalty. The provision is measured by reference to the amount initially recorded for granted rights and purchased rights (if any). The liability for any excess emissions is measured at the lower of the expected cost to purchase additional allowances or the amount of any regulatory penalty.
- *Net Liability/Net Reimbursement Right Approach:* The entity considers the emission rights it purchased and holds as a reimbursement right under IAS 37. The entity would remeasure the emission rights that it purchased and holds to fair value, but the amount is not to exceed the related provision in accordance with paragraph 53 of IAS 37. The provision is measured independently of how the settlement may be funded by the entity, which would be at the fair value of the emission rights in excess of granted rights required to settle the emissions produced.

Approach 3 – Apply a government grant approach.

Similar to the IFRIC 3 approach, emission rights granted by the government are measured initially at fair value with a corresponding government grant in accordance with IAS 20.

On the liability side, rather than measuring the liability for the obligation to deliver allowances at the present market price, the liability is measured by reference to the amounts recorded when the rights were initially granted. To the extent emissions are not covered by emission rights on hand, the excess liability is recognized at the lower of expected costs to purchase additional allowances or the amount of any regulatory penalty.

Similarities across the three approaches include the following:

- Purchased allowances are initially recorded at cost.
- An entity would need to evaluate any intangible asset for impairment. If the market value of emission rights falls below the carrying value, this does not automatically result in an impairment charge as emission rights are likely to be tested for impairment as part of a larger cash-generating unit. This ignores impairment charges that would result from a net decline in emission right market values if the revaluation model under IAS 38 were applied.
- Generally, amortization is not recorded for these cap and trade allowances since these are ultimately exchanged for emissions produced, therefore the depreciable amount is nil.
- A liability is generally recognized as emissions are produced.

The approaches outlined above generally yield the same net profit or loss outcome over the full compliance period, however they can give rise to net profit or loss differences at a point in time during the compliance period. The approaches can also potentially lead to different presentations of asset and liability amounts on the Statement of Financial Position and could also produce different results in a business combination or a sale of emission rights.

There are several views regarding classification. Some think that the allowances are considered intangible assets, while others think that inventory or financial instruments classification could be appropriate based on the intended use of the allowances.

The Group's Discussion

The Group discussed the following three questions on this topic:

1) For Approaches 1 and 3, what is considered an appropriate systematic basis for recognizing the government allocated allowances (i.e., accounted for as a government grant under IAS 20) at fair value into profit or loss?
2) What is meant by net liability when applying the net liability approach?
3) Are entities applying an approach different from what is described under Approaches 1 to 3, and can an accounting approach be mixed or tailored if it better reflects the substance of the transactions arising from the cap and trade program?

For the first question, some entities may recognize the grant into income on a straight-line basis over the compliance period, while others may recognize the grant based on when the allowances are used against the emissions produced. One Group member highlighted that the type of allowance or credit received could influence what is considered an appropriate systematic basis for recognizing the grant. For example, some credits are granted based on capital initiatives undertaken by the entity to reduce emissions produced. Therefore, a systematic basis aligned with the activities undertaken (or capital costs incurred) by the entity may better reflect the substance of the transaction. A straight-line approach or a units of pollutant production approach may be more suitable if the allocated allowance is directly related to the emissions obligation.

The Group also briefly discussed whether there is an active market for cap and trade allowances. Given the limited activity to date in Ontario, it is difficult to determine the fair value of these allowances. One Group member pointed out that the cost approach is generally more attractive to entities, and therefore, this question is often not relevant.

For the second question, several Group members noted that it is important to first determine whether the entity has an asset before considering whether the asset and liability can be netted together. The allowances are like a right for the entity to continue its operations. There is no value to these rights until the emissions produced are less than or exceed the emission rights granted and held. In other words, if an entity anticipates that all granted allowances will be used to satisfy its emission obligation, it may find one of the net liability approaches (in Approach 2) more logical. However, an entity that anticipates being granted excess allowances may find one of the other approaches to have some merit.

One Group member thought these rights share similar attributes to a derivative, a concept not contemplated under IAS 20. In terms of netting the asset and liability, one Group member thought an analogy could be drawn to the net presentation requirements for deferred taxes under IAS 12 *Income Taxes*.

Entities should also consider the consequences of not being able to obtain additional allowances. For example, the allowances enable the entity to continue operating the plant. However, if there are insufficient allowances to offset against the emissions produced and the entity is unable to acquire additional allowances or undertake other actions to constrain the emissions, the plant may not be allowed to continue operating at current capacity.

For the third question, several Group members observed it may be too early to tell what approaches entities have adopted. There does not seem to be a lot of practice questions in this area, possibly due to the fact that Ontario's first compliance period is over four years. One Group member noted that U.S. GAAP had some guidance that considered allowances to be like inventory. The allocated grants are recognized at nil and purchased allowances are recognized at cost. The allowances are measured using a weighted-average cost method, similar to inventory.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).