



HM TREASURY

Financial Reporting Advisory Board Paper

THE EC GREENHOUSE GAS EMISSION ALLOWANCE TRADING DIRECTIVE AND IFRIC INTERPRETATION 3 EMISSION RIGHTS

Issue:	To note the accounting implications of The EC Greenhouse Gas Emission Allowance Trading Directive and IFRIC Interpretation 3 Emission Rights and to approve the proposed amendment to the FReM.
Impact on guidance:	Yes
UK GAAP adaptation?	Yes
IAS/IFRS compliant?	No – adaptations are required.
IPSAS compliant?	N/A
Impact on budgetary regime?	Yes
Recommendation:	That the FRAB approves the accounting treatment and proposed wording for the FReM.
Timing:	2005-06

DETAIL

Background

1. Several governments have, or are developing, schemes to encourage reduced levels of greenhouse gas emissions in light of the Kyoto agreement, which comes into effect in 2008.
2. In April 2002 the UK launched a voluntary Emission Trading Scheme, administered by DEFRA, whereby some participants accepted a cap on their greenhouse gas emissions and

in return received tradable emission rights. The objectives of the scheme were threefold: to achieve a significant amount of absolute emission reductions at a reasonable cost, to enable businesses to gain practical experience of emissions trading, ahead of a European and International system and to help the City of London establish itself as a global centre for emissions trading.

3. The government allocated £215m, over 5 years to the scheme to provide a financial incentive for direct participants who voluntarily agreed to absolute caps on their emissions.
4. In January 2005 the European Union Greenhouse Gas Emission Trading Scheme (EU ETS) commenced operation as the largest multi-country, multi-sector, Greenhouse Gas Emission Trading Scheme, world-wide. The scheme is based on Directive 2003/87/EC, which came into force on 25 October 2003. However, no guidance for accounting for such schemes formed part of the EU Greenhouse Gas Emission Allowance Trading Directive.
5. Entities participating in a cap and trade emission rights scheme are usually set a target to reduce their emissions to a specified level (the cap). The participant is issued allowances equal in number to its cap by a government, or government agency. Allowances may be issued free of charge or participants may pay the government for them. Schemes usually operate for defined compliance periods, normally on an annual basis. Allowances are usually issued to each participant at the beginning of a period and actual emissions are normally verified after the end of the period in question.
6. A participant is free to buy and sell allowances and therefore has three options:
 - It can limit its emissions to its cap, or
 - It can reduce its emissions below its cap and sell (or some schemes allow participants to carry forward surplus allowances) the allowances that it does not require, or
 - It can produce emissions which exceed its cap in which case it must buy additional allowances for the excess emissions and / or incur a penalty.

IFRIC Interpretation 3 Emission Rights

7. The IASB's International Financial Reporting Interpretations Committee (IFRIC) noted that there was no guidance for the accounting for a cap and trade emissions rights scheme and no consensus had emerged among market participants on what the accounting should be. IFRIC concluded that it should therefore develop an Interpretation.
8. In December 2004, IFRIC issued its final interpretation (IFRIC Interpretation 3) on Emission Rights, which is effective for financial reporting periods beginning on or after 1 March 2005.
9. The Interpretation deals with how to account for a 'cap and trade' emission rights scheme that is operational and specifically addresses the following questions:

- i. does a cap and trade scheme give rise to i) a net asset or liability, or ii) an asset (for allowances held) and a liability, deferred income and / or income?
- ii. if a separate asset is recognised, what is the nature of that asset?
- iii. if a separate liability, deferred income and / or income is recognised, what is the nature of that item and how is it measured?

10. The consensus in the Interpretation is that a Cap and Trade scheme gives rise to:

- i. an asset for allowances held,
- ii. a government grant, and
- iii. a liability for the obligation to deliver allowances equal to emissions that have been made.

That is, it does not give rise to a net asset or liability.

11. In terms of measurement, the Interpretation designates allowances, whether issued by government or purchased, as intangible assets and they should be accounted for in accordance with IAS 38. Allowances which are issued for less than their fair value should be measured initially at their fair value and the difference between the amount paid and the fair value should be reported as a government grant, in accordance with IAS 20. Initially the grant should 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 allowances were issued, regardless of whether the allowances are held or sold. Subsequently an entity can choose to measure them under the cost or revaluation models

12. As emissions are made, a liability should be recognised for the obligation to deliver allowances equal to the emissions that have been made. This liability is regarded as a provision which is within the scope of IAS 37. It should be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. This will usually be the present market price of the number of allowances required to cover emissions made up to the balance sheet date.

ASB Consensus

13. In May 2003, the UITF issued a draft abstract on accounting for emission rights based on IFRIC's draft Interpretation D1 Emission Rights. However, the UITF had reservations about the different bases for measuring and presenting changes in the component assets and liabilities of the proposed accounting model. There are two specific areas of concern:

1. Emission allowances should be accounted for in accordance with IAS 38. Allowances that are issued for less than fair value should initially be recognised at fair value. Subsequently, an entity can choose to measure allowances under the cost or revaluation models. As emissions are made, a liability should be recognised for the obligation to deliver the allowances. The

liability should be accounted for as a provision in accordance with IAS 37. The liability will usually be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. This will usually be the present market price of the number of allowances required to cover emissions made up to the balance sheet date. *This means that entities could be measuring allowances on a cost basis whilst the liability to deliver the allowances is measured on a current market value basis.*

2. Even if the revaluation model is applied, mismatches in relation to the profit and loss will still occur; changes in the market value of allowances held will usually be recognised in equity, whereas changes in the market value of the liability are recognised through profit and loss. Also, where allowances are allocated for less than the fair value, under SSAP 4, the difference should be accounted for as a government grant. However, IFRIC concluded that since a deferred credit is not a liability under the framework, it would be inappropriate for it to be re-measured during the year to reflect changes in the value of allowances.
14. The UITF noted that the achievement of the most appropriate accounting treatment was constrained by other accounting requirements relating to intangible assets and grants. Respondents shared concerns about these issues. During the consultation period IFRIC noted the concerns regarding the mixed measurement model. IFRIC has asked the IASB to propose an amendment to IAS 38 that would require emission allowances traded in an active market to be measured at fair value with changes in value recognised through profit or loss. The IASB also has a project to replace IAS 20 Accounting for Government Grants and Disclosure of Government Assistance. However, IFRIC noted that amendments to IASs 20 and 38 might not be finalised for some time. IFRIC concluded that the need for timely guidance to prevent divergent practices outweighed the disadvantage that the Interpretation might be amended in the medium term. Therefore IFRIC issued the Interpretation, in the context of current IASs, and noted that changes may be necessary when the IASB amends IAS 20.
15. The UITF subsequently concluded, as it is likely that changes will be made to the accounting required by the Interpretation, and that these will give rise to a better representation of the economics of participation in emission trading schemes, that it would not issue a UITF Abstract at this time.

Treasury proposal

16. As outlined above, we do not currently have UK guidance for the accounting for cap and trade emission rights schemes. The Treasury therefore has two options:
1. to do nothing i.e. delay issuing any form of guidance as to how entities covered by the requirements of the FReM should account for their participation in the EC Greenhouse Gas Emission Allowance Trading scheme, until the ASB has issued guidance for the UK, or
 2. to provide accounting guidance for entities observing the requirements of the FReM, prior to guidance being issued by the ASB.

17. There are a number of reasons to support the Treasury issuing guidance now:

- the Treasury has already received requests for guidance on the accounting for a cap and trade emission rights scheme and expects to receive further requests for advice, now that the EU scheme is mandatory,
- a consistent approach across government bodies is advantageous as accounts of individual bodies feed into the higher level Central Government and Whole of Government Accounts and the work of the FRAB may influence other accounting guidance, and
- the concerns expressed by the ASB are not considered to cause similar concerns for entities covered by the accounting guidance in the FReM. This is discussed in further detail below.

18. The first issue is that entities who elect to apply the cost model would be measuring the allowance on a cost basis, whilst the liability would be measured on a current basis. Under FRS10 Goodwill and Intangible Assets, intangible assets with readily ascertainable market values may be revalued by reference to those market values. Therefore the FReM could direct entities to value allowances, as part of a cap and trade scheme, on a current basis. This would eliminate concerns of mismatches in valuation bases between the asset (the allowance) and the liability (the obligation to deliver allowances equal to emissions that have been made). This policy would also be consistent with the valuation basis for tangible fixed assets, which are carried at valuation, at balance sheet date, by entities covered by the FReM.

19. The second issue is that changes in the value of the allowances would be taken to the government grant / revaluation reserve, whereas changes in the value of the provision would be taken to the OCS. The value of allowances and the provision may vary in accordance with the market value of allowances. Where the market value for allowances changes the Treasury is content that changes in the value of the intangible asset will be credited to the government grant / revaluation reserve whilst associated changes in the value of the provision would be taken to the OCS.

20. Linked to the second issue is one further concern that where allowances are allocated for less than fair value, under SSAP4, the difference should be accounted for as a government grant. In accordance with the Interpretation, the unamortised value of deferred income relating to the grant is not re-measured during the year to reflect changes in the value of allowances. This results in a further mismatch in the profit and loss; the liability is revalued on a current basis and associated charges to the profit and loss are therefore on a current basis, whereas the related income (government grant reserve) credited to the profit and loss, would be on a cost basis.

21. The FReM requires assets financed in whole or in part by government grants to be revalued and depreciated in the same way as other fixed assets. The government grant reserve should be credited with the same proportion of the amount of the revaluation which the amount of the grant bears to the acquisition cost of the asset. The remainder of the revaluation is credited to the revaluation reserve. Therefore entities covered by this guidance would not be affected by the mismatch outlined in paragraph 20 above.

22. As most of the concerns expressed by the ASB are not considered to present the same level of concern for entities covered by the FReM, the advantage of providing accounting guidance for entities covered by the FReM is considered to outweigh the disadvantage of future possible amendments to the guidance. Therefore the proposal is to implement option 2 and include guidance within the FReM as to how entities should account for participation in a cap and trade emission trading scheme.

UK GAAP compliance

23. FRS10 Goodwill and Intangible Assets permits intangible assets with readily ascertainable market values to be revalued by reference to those market values. Entities covered by the FReM are required to revalue intangible assets, with readily ascertainable market values, to a current value i.e. the option within FRS10 to value intangible assets at cost is withdrawn.

IAS/IFRS compliance

24. The proposed accounting guidance includes some adaptations to the Interpretation:
- i. The option to use the cost model for valuing allowances would not be permitted for entities covered by the FReM i.e. entities would be required to measure allowances on a current basis.
 - ii. When allowances are issued to entities at less than fair value the difference is credited to a government grant reserve. Entities covered by the FReM should apply the revaluation model in measuring allowances. When allowances increase in value the government grant reserve should be credited with the same proportion of the amount of the revaluation, which the amount of the grant bears to the asset's acquisition cost. This treatment differs to the Interpretation which does not permit entities measuring allowances on a current basis, to revalue the deferred credit.

Proposed amendment to the Government Financial Reporting Manual

25. See Annex A for the proposed amendments to the FReM.

Impact on the budgetary regime

26. When allowances are issued this will impact the balance sheet with an increase in assets and a corresponding credit to the government grant reserve (if issued at less than fair value) or cash, if the allowances are purchased. When emissions are made, a liability is recognised as the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The liability is reported within the balance sheet and charged to the OCS.
27. As emissions are made, the entity should apply the allowances to offset the liability by recognising in income the proportion of government grant that offsets the emissions. This reduces the government grant in the balance sheet and a credit is taken to the OCS as income is released.

28. If allowances are revalued this impacts the balance sheet by increasing / decreasing the value of the asset (allowance) with a corresponding credit / debit to the revaluation reserve / government grant reserve (or OCS if there is an impairment). If emissions are revalued this increases or decreases the value of the liability (provision) in the balance sheet with a corresponding charge / credit to the OCS.
29. At the end of the compliance period the obligation is settled by debiting the provision and crediting the asset (allowance.)

Summary and recommendation

30. The concerns expressed by the ASB regarding the accounting guidance in the Interpretation are not considered to cause similar concerns for entities observing the accounting guidance within the FReM. The Treasury has received requests for advice as to how entities should account for their participation in a cap and trade emission rights scheme and expects to receive further requests for accounting guidance. A consistent approach across government bodies is advantageous as accounts of individual bodies feed into the higher level Central Government and Whole of Government Accounts and the work of the FRAB may influence other accounting guidance. Therefore, the recommendation is that the Treasury should include accounting guidance within the FReM, based on the principles of the Interpretation with the adaptations as discussed above and outlined at annex A.
31. The Board is asked to approve the proposed amendments to the FReM.

HM Treasury

June 2005

PROPOSED AMENDMENT TO THE GOVERNMENT FINANCIAL REPORTING MANUAL

5.3 Intangible assets

5.3.1 The following accounting standards deal with accounting for intangible assets:

FRS10 *Goodwill and intangible assets* (paragraphs 5.3.2 to 5.3.4);

FRS11 *Impairment of fixed assets and goodwill* (paragraphs 5.2.31 to 5.2.35); and

SSAP13 *Accounting for research and development* (paragraphs 5.3.5 to 5.3.7).

In addition, entities should have regard to:

UITF Abstract 27 *Revision to estimates of the useful economic life of goodwill and intangibles* (paragraphs 5.3.8 and 5.3.9) , **and**

IFRIC Interpretation 3 *Emission Rights*

IFRIC Interpretation 3 Emission Rights

Applicability

5.3.10 IFRIC Interpretation 3 applies, as adapted in paragraph 5.3.16 to all entities covered by this Manual.

IFRIC Consensus

5.3.12 The consensus is that a cap and trade scheme gives rise to:

- a) an asset for allowances held,
- b) a government grant, and
- c) a liability for the obligation to deliver allowances equal to emission that have been made.

It does not give rise to a net asset or liability.

5.3.13 Allowances, whether issued by government or purchased, are intangible assets. Allowances that are issued for less than their fair value shall be measured initially at their fair value. Subsequently, entities are permitted to choose whether to measure allowances under the cost or revaluation model.

5.3.14 When allowances are issued for less than their fair value, the difference between the amount paid and fair value is a government grant. Initially the grant shall 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 allowances were issued, regardless of whether the allowances are held or sold. The un-amortised value of deferred income relating to the grant is not re-measured during year to reflect changes in the value of allowances

5.3.15 As emissions are made a liability is recognised for the obligation to deliver allowances equal to emissions that have been made. This liability is a provision. It shall be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. This will usually be the present market price of the number of allowances required to cover emissions made up to the balance sheet date.

Adaptation of IFRIC 3 for the public sector context

5.3.16 The following adaptations to IFRIC 3 apply to entities required to prepare their Financial Statements in accordance with the guidance within this manual:

- a. In the same way as intangible assets are normally measured on a current basis, entities covered by this manual should value allowances on a current basis, that is the option within FRS10 *Goodwill and Intangible Assets*, which would permit allowances to be valued at cost, is withdrawn.
- b. Entities covered by this manual should revalue and depreciate allowances financed in whole or in part by government grants, in the same way as other assets. The government grant reserve should be credited with the same proportion of the amount of the revaluation which the amount of the grant bears to the acquisition cost of the asset. The remainder of the revaluation should be credited to the revaluation reserve.

ANNEX C

IMPACT ON WHOLE OF GOVERNMENT ACCOUNTS

THE EC GREENHOUSE GAS EMISSION ALLOWANCE TRADING DIRECTIVE AND IFRIC INTERPRETATION 3 EMISSION RIGHTS

Issue:	To note the accounting implications of The EC Greenhouse Gas Emission Allowance Trading Directive and IFRIC Interpretation 3 Emission Rights and to approve the proposed amendment to the FReM
Impact on guidance:	Yes
UK GAAP adaptation?	Yes
IAS/IFRS compliant?	No – adaptations are required
IPSAS compliant?	N/A
Impact on budgetary regime?	Yes
Recommendation:	That the FRAB approves the accounting treatment and proposed wording for the FReM.

Does this paper propose a change in accounting policy? Yes³

Does the impact on Department Yellow mean that additional disclosures are required? No³