IASB/FASB Joint Board Meeting
17-18 November 2010
FASB Only Education Session
November 10, 2010

Staff Paper	IASB Agenda reference	**7B**
	FASB Agenda reference	**8B**

Project	**Emissions Trading Schemes**
Topic	**Initial and subsequent measurement of purchased allowances (assets) (cap and trade scheme)**

Introduction

1. The objective of this paper is to address the initial and subsequent measurement of the purchased allowances (assets) in a cap and trade scheme.

Summary of staff recommendations

2. The staff recommend that purchased allowances should be measured at fair value with remeasurement (Model 1). This is consistent with the boards' tentative decisions in October 2010 to measure the allocated allowances at fair value with remeasurement. The staff believe that purchased and allocated allowances should be measured consistently because there is no fundamental difference between allocated and purchased allowances once in the possession of an entity. Thus if the boards adopt a different measurement model for the purchased allowances, the staff also recommend that the boards' reconsider the tentative decision to measure the allocated allowances at fair value with remeasurement.

Prior board decisions

3. At the September 2010 joint board meeting, the FASB and the IASB tentatively decided that:

   (a) purchased and allocated allowances should be recognised as assets, and

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(b) a liability exists when the allocations are allocated (the liability for the allocation), because the definition of a liability is met.

4. At the October 2010 joint board meeting, the FASB and the IASB tentatively decided that allocated allowances should be initially and subsequently measured at fair value. Furthermore, the boards tentatively decided that the price of the allowances, that will be used as one input[1] for the measurement of the liability for the allocation[2], would be measured consistently with the allocated allowances. The boards discussed the measurement of the purchased allowances, however no decisions were reached.

Structure of the paper

5. The possible measurement models for purchased allowances are as follows:

   i. Model 1 – Fair value at initial and subsequent measurement

   ii. Model 2 – Intended use approach

6. This paper does not address the recognition of the liability for excess emissions above the initial allocation. The issue is discussed in IASB Agenda Paper 7A/FASB Agenda Paper 8A.

7. This paper does not address the measurement of an entity's liabilities in an emissions trading scheme. This issue is also discussed in IASB Agenda Paper 7A/FASB Agenda Paper 8A. In that paper, the staff recommend that the price of allowances that will be used to measure the liabilities is consistent with the measurement of the related allowances (both purchased and allocated). In light of the staff's recommendation in this paper, the price of allowances should be initially and subsequently measured at fair value (fair value with remeasurement model). Measuring the price of allowances consistently in the measurement of the liabilities and the allowances (assets) is important, because applying the same

[1] The measurement of the liability for the allocation would be based upon price of the allowances (P) and the quantity of the allocated allowances to be returned (Q).

[2] The boards' requested additional analysis regarding the quantity input for the measurement of the liability for the allocation. This issue is discussed in IASB Agenda Paper 7A/FASB Agenda Paper 8A.

measurement principles to both the liabilities and the allowances will eliminate the risk of measurement mismatch.

8. In addition, this paper does not discuss whether the reporting entity should be permitted or required to present the purchased and allocated allowances and the related liabilities on a net basis. This issue is discussed in IASB Agenda Paper 7C/FASB Agenda Paper 8C.

9. The staff believe that the measurement principles in this paper would be applied to allowances that may be held by entities subject to an emissions trading scheme (which may be a voluntary or statutory scheme), and entities that may otherwise hold or trade allowances.

Analysis of the possible accounting models for initial and subsequent measurement of the purchased allowances

10. At the October 2010 joint meeting, the boards tentatively decided that allocated allowances should be measured at fair value with remeasurement, and the liability for the allocation should be consistently measured, however the boards did not reach a decision on purchased allowances.

11. The staff believe that regardless of which measurement model is chosen, the measurement model for purchased and allocated allowances should be the same. The staff do not believe there is a fundamental difference between allocated and purchased allowances once in the possession of an entity. If the allowances are not consistently measured, entities would need to track them separately. Furthermore, inconsistent measurement of the purchased and allocated allowances may result in measurement of the liability that may not make sense. That is, if the liability for the allocation is covered by both allocated and purchased allowances, the liability would be measured consistently with the related purchased *and* allocated allowances which have different measurement attributes. Thus this approach would result in a mixed measurement model for a single element.

12. Three possible measurement models were presented in the October 2010 IASB agenda paper 5A/FASB Agenda paper 7A. Only two of those models received significant support and therefore only those models are presented in this paper for the measurement of purchased allowances.

13. The possible accounting models for the initial and subsequent measurement of the purchased allowances are as follows:

    i. Model 1 – Fair value at initial and subsequent measurement

    ii. Model 2 – Intended use approach

        1. *Held for use* – allowances determined to be held for use will be used to settle liabilities under the scheme (that is, not sold) and will be initially measured at fair value and will not be remeasured in subsequent periods.

        2. *Trading* – allowances determined to be traded in the market will be measured in accordance with **Model 1 –** Fair value with remeasurement.

Staff Analysis

Model 1 - Fair value with remeasurement[3]

14. Model 1 requires measurement of purchased allowances at fair value initially and subsequently at each reporting date.

15. The fair value of each allowance should be determined using the measurement principles in ASC Topic 820 *Fair Value* and the standard being developed from IASB May 2009 Exposure Draft *Fair Value Measurement*[4]. Markets exist for allowances and thus a reliable estimate of fair value is available for the asset.

[3] Remeasurement refers to the change in fair value due to the price change in the assets experienced in the active market.

[4] Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The staff's understanding is that for most emissions trading schemes in existence, markets are active enough to provide reliable information for entities to make estimates of fair value.

16. Gains and losses incurred on the remeasurement of the purchased allowances would be recognised in earnings (profit or loss). The staff observe that if the number of allowances on hand exceeds the liabilities under the scheme, an entity may experience volatility in earnings as the price of allowances fluctuates.

17. However, the staff also observe that when the liabilities are uncovered (ie an entity does not hold enough allowances to 'cover' the liabilities under the scheme), volatility in earnings will also result as the price of the allowances fluctuates. This particular volatility will occur with all of the measurement models.

18. The staff observe the boards' concern that volatility on excess purchased allowances may not be appropriate given that the allowances are a 'cost of production'. (This concern is discussed further below.) The staff believe that one solution to this concern may be to apply hedge accounting when the purchased allowances are intended to be used to settle a forecasted transaction (ie a future emission liability). The staff observe that purchased allowances do not appear to be currently eligible for hedge accounting[5]. However, if this model is selected, the staff could explore whether the hedge accounting model could be expanded. The staff observe that there are currently differences in hedge accounting requirements in IFRS and US GAAP and that the boards are currently redeliberating hedging activities.

Model 2 – Intended use approach

19. Model 2 requires an entity to determine how it *intends* to use the purchased allowances in order to establish the initial and subsequent measurement attributes. The allowances would be classified as held for use or trading as outlined above in paragraph 13(ii).

20. This model would require classification of purchased allowances as held for use if the entity has the positive intent and ability to hold those allowances until settlement with the scheme administrator. Furthermore, held for use classification

[5] If the purchased allowances were a hedging instrument, they would not qualify under IAS 39 *Financial Instruments: Recognition and Measurement* and ASC Topic 815 *Derivatives and Hedging* because the purchased allowances are not financial instruments under IAS 39 or derivatives under ASC Topic 815.

is precluded for purchased allowances if the reporting entity expects to sell or trade them.

21. However, if the boards were to adopt this model, a number of issues related to the implementation of this model would need to be discussed at future board meetings. While these issues are inter-connected, we have summarized them into the following categories:

(a) defining an entity's intent to determine classification,

(b) determining whether intent should be measured on a portfolio or individual allowance basis,

(c) determining the level within the organization intent is assessed (ie reporting entity, subsidiary, etc.), and

(d) whether trading one allowance for another (ie one 'vintage year' allowance for a different 'vintage year' allowance) constitutes 'trading' in this model.

22. It is necessary to address these issues and provide clear guidance, because without clear guidance diversity in practice could result. Thus, entities could account differently for transactions that are economically the same. This guidance would also be important should the boards permit net presentation of the assets and related liabilities on the balance sheet, because only held for use allowances would be eligible for netting[6]. Furthermore, because this model is a mixed attribute model for subsequent periods, if clear guidelines do not exist to differentiate between held for use and trading, entities could manipulate earnings simply by changing the designation of the allowances to match trends in the active market.

(a) Defining Intent

23. An important issue to address in this model is defining criteria for determining an entity's intent for the use of allowances and thus whether the held for use or

[6] In IASB Agenda Paper 7C/FASB Agenda Paper 8C, some staff recommend that an entity should present allowances and liabilities using a form of linked presentation, if an entity intends to use those allowances to settle liabilities under the scheme. The staff believe that an entity would not be able to intend to use allowances to settle liabilities if those allowances are classified as trading.

trading classification is appropriate. One approach may be to presume all allowances are held for use until an entity formally documents that it should be classified as a trading asset.

24. In addition, defining permissible changes in intent, and how those changes may or may not arise would also be important. Those changes could arise through changes in the emission trading scheme (for example, a reduction in the number of allowances required to be returned by the scheme administrator) or through other events that may be unusual for an entity and could not have been reasonably anticipated. Alternatively, an entity may simply change its intent due to changes in its core business. Defining these events and determining how their occurrence impacts an entity's assessment of its intentions, would be important for the operation of this model. For example, would some or all of these events limit an entity's ability to assert its intention and classify allowances to one of the categories? In particular, once an entity has changed its intent for an allowance[7], could it change it back in the future?

25. Carefully defining criteria for determining an entity's intentions, as well as possible changes in those intentions is important, because without those criteria, an entity may be able to manipulate the timing of the recognition of gains or losses in earnings. For example, an entity could reclassify allowances based on fluctuations or trends in the market, and not based upon actual changes in intentions.

(b) Portfolio or individual assets

26. Another important issue is whether to classify allowances at a portfolio or an individual asset level. This particular issue could be significant for entities that purchase large quantities of allowances to settle future liabilities. In addition, this issue must be considered in the light of the discussions related to changes in intentions.

[7] The discussion of whether intent should be based upon a portfolio of allowances or an individual allowance is discussed below.

27. For example, if changes in intention are only permitted when there are factors outside the entities control, and entities were required to evaluate allowances on a portfolio basis, this may affect an entity's ability to sell allowances that it initially intended to 'hold for use', or may affect its ability to classify other portfolios of allowances as 'held for use'. As a result, an entity's true position within the scheme may not be transparent to users of financial statements. Furthermore, evaluating allowances on a portfolio basis could remove some of the flexibility for entities to sell individual allowances and use the proceeds to implement emission reduction efforts. This is because an entity may be hesitant to sell individual allowances because this action would call into question its intended use for the rest of its allowances in the portfolio.

28. Conversely, if the boards were to assess allowances on an individual basis, that may afford too much flexibility to entities. For example, an entity could take advantage of market fluctuations to selectively reclassify a given quantity of allowances to record gains or losses to manipulate earnings.

(c) At what level within the organization is intent assessed

29. A further issue related to defining intent is to determine at what level of the organization it is appropriate to determine intent and to what level should the classification of the allowances be applied. For example, should decisions about intent be made by the reporting entity or at the subsidiary level? In addition, should the classification of the allowances be based upon the intentions of the subsidiary, or should intentions be assessed at the reporting entity level? Another issue is how the existence of a trading division of an entity factors into the decision of defining the level of the organization that intent is applied? Furthermore, would an inappropriate change in intentions at one subsidiary affect the classifications for the rest of the entity?

(d) *Trading one allowance for another*

30. Some entities may trade one allowance for another, in particular an allowance that is designated for one particular vintage year, for an allowance for another vintage

year. This example raises a number of issues that should be considered. For example, whether this exchange constitutes 'trading' in this model and how this exchange may impact an entity's determination of its intentions or changes in intentions.

31. In addition, trading one allowance for another would be a non-monetary exchange, and thus if an entity has classified the allowances as held for use, we would need to consider the value at which the exchange should be measured. There is guidance on measuring non-monetary transactions in IFRS[8] and U.S. GAAP[9]. Thus the analysis of this issue would include considering whether existing guidance is applicable and how it may be applied to this situation or alternatively, defining stand-alone guidance for such exchanges of allowances that are classified as held for use. It is important to have guidance for this issue to eliminate the possibility of an entity manipulating gains or losses for non-monetary exchanges of allowances classified as held for use.

Summary

32. The issues presented in the preceding paragraphs are meant to provide an overview of the issues related to the intended use model. The staff believe these issues would need to be addressed if this model is adopted for the measurement of purchased allowances. The staff observe that some of these issues have been brought before the boards in previous projects and the boards have not been able to achieve a consensus.

Held for use – Fair value with no remeasurement

33. This model differs from Model 1 described above, because it does not require remeasurement. Therefore, this model would require purchased allowances classified as held for use to be initially measured at fair value with no remeasurement for price changes experienced in the active market for allowances

[8] IAS 16 *Property, Plant and Equipment* paragraph 24 includes guidance for measuring non-monetary exchanges of property, plant and equipment. Similar guidance exists in IAS 38 *Intangible Assets* paragraph 45.

[9] ASC Topic 845 *Nonmonetary Transactions.*

at each reporting date. This model would not result in gains and losses being recognised in the income statement for price changes in the allowances.

34. The fair value with no remeasurement model also would require an impairment model for the assets. The staff observe that guidance for impairment testing of assets exist in both IFRS and US GAAP. For entities applying IFRS, the impairment guidance in IAS 36 *Impairment of Assets* can be applied to the allowances. However for entities applying US GAAP, the staff would recommend incorporating separate guidance into the final due process document for emissions trading schemes from ASC Topic 320 *Investments – Debt and Equity Securities*. In particular, an entity should determine whether a decline in fair value below the carrying amount is other than temporary. Evidence of a loss in value might include, but would not necessarily be limited to, absence of an ability for an entity to utilize the allowance to settle its emission liability to the scheme administrator. However, a decline in the quoted market price of an allowance below its carrying amount is not necessarily indicative of a loss in value that is other than temporary.

35. If the decline in fair value is determined to be other than temporary, the carrying basis of the allowance shall be written down to fair value as the new carrying basis and the amount of the write-down should be included in earnings. The new carrying basis should not be changed for subsequent recoveries in fair value.

Pros and Cons of measurement models

36. Proponents of Model 1 assert that reflecting the purchased allowances at fair value with remeasurement would faithfully represent the substance of the allowances, which operate much like a currency. Thus the principles of this measurement model would be consistent with the measurement of a monetary item denominated in a foreign currency.

37. Proponents also believe that Model 1 is more appropriate because entities are permitted to sell and trade allowances in the markets that have developed and the financial statements should reflect the price that would be received should the entity decide to trade (ie fair value).

38. Proponents of Model 1 observe that this tradable aspect of allowances cannot be ignored in the measurement model. For example, even though an entity may have classified allowances as 'held for use' in Model 2, the tradable aspect of the allowances enables an entity to sell the purchased allowances, record a gain, and easily repurchase allowances in the market.

39. Proponents of Model 1 also believe that when an entity purchases allowances before it has recognised a liability, the entity is speculating that the price of allowances will increase and this speculation should be reflected in earnings, even though it may result in volatility. These proponents also point out that although Model 2 attempts to limit the volatility associated with the purchased allowances, entities can still have volatility if they have an uncovered liability (ie the entity does not hold enough allowances to cover liabilities related to the scheme). Since the entity would experience volatility for an uncovered liability because it does not have sufficient allowances to settle, proponents do not understand the rationale for avoiding volatility for the purchased allowances nor do they believe it is appropriate.

40. Proponents of Model 2 do not believe that entities purchasing allowances in anticipation of a future emission liability are speculating on the market. They would argue that these purchased allowances are akin to inventory and their cost is a 'cost of production'. Thus, the allowances should be measured like inventory (ie at the cost to purchase without remeasurement) and the entity should not be subject to volatility in earnings for price changes (which would result from Model 1).

41. However, opponents of Model 2 (who support Model 1) highlight that although emissions are generated by production, the allowances must be provided to a third party and thus they are not 'consumed' in production like inventory. Again, opponents believe that the allowances are more akin to a currency that will be used to settle a liability that results from production. Thus the emissions liability appears to be more like a tax liability. Therefore given that liabilities, including tax liabilities, would be remeasured to reflect the fair value of resources required

42. Proponents of Model 1 argue that Model 2 would not produce useful information for users, because it is complex and it would reduce comparability between entities. Specifically, they have concerns that it will be difficult to define an entity's intent as *Trading* or *Held for use* both initially and as its intent changes over time. This can be further complicated by entities that are both emitters and traders. Further, they believe entities are likely to define the same activities differently resulting in different accounting treatment for transactions that are in substance the same. Proponents of Model 1 also note that Model 2 may require impairment, tainting, and reclassification rules that would create additional complexities considering that the allowances are created and designed solely for the settlement of liabilities in an emissions trading scheme.

43. Proponents of Model 2 note that by matching the entity's intention with the accounting for the purchased allowances, this model is the most faithful representation of what would actually happen. Furthermore, for an entity that intends to use all its purchased allowances to settle its emission obligation, the model does not burden those entities with the additional complexities and costs of fair value remeasurement each reporting period. In addition, this model would eliminate the volatility created by remeasuring, when an entity purchases allowances intended to cover an expected future shortfall in allowances or excess allowances are held (this would result from Model 1 – fair value with remeasurement).

44. Opponents of Model 2 note that although there are additional complexities and costs associated with fair value remeasurement, information regarding the fair value may be a required disclosure, and thus an entity would be required to determine fair value despite the measurement model.

Staff Recommendation

45. The staff recommend measuring purchased allowances using Model 1 – fair value with remeasurement. This model would faithfully represent the substance of the allowances, which are akin to a currency that will be used to settle a liability that would otherwise be measured at fair value with remeasurement. Thus, measuring the purchased allowances at fair value with remeasurement would reflect consistent measurement between the two related items. In addition, this model would avoid the complexities of rules around impairment, tainting, and reclassifications.

46. The staff observe that this model is consistent with the boards' tentative decision in October 2010 to measure the allocated allowances at fair value with remeasurement. Should the boards' disagree with this staff recommendation, the staff will request the boards' to reconsider this tentative decision in the light of the staff's belief that purchased and allocated allowances should be measured consistently.

Question 1
Q1: Do the boards agree with the staff recommendation that the purchased allowances should be initially and subsequently measured at fair value? If not, which model do the boards support and why?