Pollutant Pricing Mechanisms

Project update

Objective

1 The objectives of the session are:

(a) Provide an update on the status of a potential IASB project on Pollutant Pricing Mechanisms[1] (PPMs)

(b) Provide FR TEG-CFSS members a summary of the feedback reported by the EFRAG Secretariat to the IASB based on the feedback gathered from EFRAG's constituents; and

(c) Obtain input from FR TEG-CFSS members in preparation for the ASAF meeting that will take place in July 2024.

2 The paper is structured as follows:

(a) Status of the IASB project

(b) Summary of the EFRAG Secretariat response to the IASB's questionnaire

(c) EFRAG Secretariat views

(d) Agenda Papers

(e) Appendix 1: Overview of projects undertaken by other standard setters

(f) Appendix 2: Previous IASB work on pollutant pricing mechanisms

Status of the IASB project

3 Following the outcome of its Third Agenda Consultation, the IASB added a project on PPM to its reserve list.

4 Since then, several stakeholders have suggested that the IASB should prioritise a project on PPM. They argued that PPMs were increasing in prevalence and that deficiencies in reporting existed. In response to these comments, the IASB staff undertook horizon scanning activities to assess whether the situation has changed.

[1] Also referred to in this agenda paper as carbon credit schemes.

5 The horizon scanning activities entailed the following[2]:

(a) Questionnaire addressed to ASAF members (national standard setters) asking about the prevalence and significance of PPMs (responses from 20 jurisdictions);

(b) Questionnaire addressed to users asking about the prevalence of PPMs and on the usefulness of the information received (responses from 17 users);

(c) Meetings with two regulators and Emerging Economies Group;

(d) Review of the financial statements of 16 entities to understand accounting and disclosures of PPMs; and

(e) Review of the World Bank annual report about key developments in carbon pricing.

6 The IASB staff drew the following observations from the horizon-scanning activities:

(a) The prevalence of both compliance schemes and voluntary schemes is increasing;

(b) Compliance markets are more mature than voluntary markets and the accounting issues are better defined;

(c) There is diversity in accounting for both compliance schemes and voluntary schemes;

(d) Limited outreach with users suggests that they receive insufficient information about an entity's participation in both types of schemes, although some of the requested information may be outside the scope of financial statements; and

(e) It is difficult to assess the materiality of these schemes to IFRS reporters. However, an increasing number of IFRS reporters are participating in these schemes, and the effects are material to some entities.

7 Agenda papers 08-04 (paragraphs 22 to 37) and 08-05 include additional details of the feedback the IASB collected through the questionnaire from users, regulators and national standard setters (NSS). A summary of the feedback provided by the EFRAG Secretariat is included below in paragraphs 9 to 19.

8 A project on PPMs is also the EFRAG proactive agenda as a reserve list project. The EFRAG Secretariat plans to perform some preparatory work in Q3 2024 to assess the prevalence, significance and accounting approaches of PPM in the financial statements of European entities. In addition, the EFRAG Secretariat has consulted and will continue to consult the IASB staff on the scope of a potential EFRAG project (i.e., to ensure EFRAG's efforts are complementary rather than duplicative).

Summary of the EFRAG Secretariat response to the IASB's questionnaire

9 The IASB questionnaire intended to obtain feedback on several matters related to compliance and voluntary carbon credit schemes and on aspects related to entities that generate carbon credits. Responses were requested from ASAF members on a jurisdictional level.

10 EFRAG obtained feedback from five national standard setters (NSS) (ANC, ASCG, CNC, DASC and NASB) and a large audit firm.

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[2] Additional details of the horizon scanning activities are included in paragraphs 17 to 21 of agenda paper 08-04.

Compliance carbon credit schemes

11 For EU companies the most relevant scheme is the EU Emission Trading System (ETS). NSS indicated that even though some companies may be significantly affected by compliance carbon credit schemes, this was not yet widely spread. However, it was noted that it is expected that the importance and impact of ETS across entities will increase.

12 Some NSS identified diversity in practice. It was indicated that companies typically recognise acquired emission rights either as inventories, intangible assets or other assets. In this regard, some jurisdictions provide some guidance to help entities account for these compliance schemes under local GAAP, but the need for IFRS guidance was highlighted by NSS.

13 The large audit firm noted that, with regards to compliance schemes, the main challenges lay on the liability side but acknowledged that these challenges may be dealt with by the IASB Provisions-Targeted improvement project.

14 NSS indicated that entities in their jurisdictions participate in voluntary schemes to offset their emissions. Some of the NSS considered that the prevalence of these schemes is increasing.

Voluntary carbon credit schemes

15 Some NSS considered that the impact of voluntary carbon credits on entities from their jurisdiction was not relevant while a few others were not aware of it. However, they were all of the view that these schemes give rise to accounting issues such as:

(a) Which IFRS an entity uses to account for the investment in the carbon reduction project.

(b) Which IFRS an entity uses to account for the carbon credits that are generated.

(c) When does an entity recognise the carbon credit?

(d) How are carbon credits subsequently measured? (in case these are considered to be assets)

16 Some of the NSS also indicated there is diversity in practice in their jurisdictions.

17 The large audit firm stressed the lack of regulation and cohesiveness of the voluntary carbon credit schemes in aspects such as the determination of when carbon credits are generated, how they are granted and certified or how carbon credits are retired.

18 It was also noted that EU entities obtain Renewable Electricity Certificates (REC) which are electronic certificates that prove that a certain amount of electricity, gas or biofuel is of renewable origin. Power Purchase Agreements (PPA) transactions, which give rise to REC, are increasing in Europe.

Entities that generate or issue carbon credits

19 Feedback on this section was limited. One NSS noted that the sales of RECs as a separate commodity were significant for entities in the renewable energy industry (it contributed a quarter or third of the net profit). In its view, RECs give rise to measurement issues.

EFRAG Secretariat views

20 Based on the feedback and IASB staff analysis along with the outreach and data gathered by the EFRAG Secretariat, we are of the view that the IASB should prioritise a project on PPM. To recap, the feedback so far indicates the following:

(a) The growing importance and increasing prevalence of compliance carbon credit schemes across Europe (mainly EU ETS);

(b) Some NSS consider that the prevalence of voluntary carbon credit schemes is also increasing;

(c) The NSS respondents are of the view that voluntary carbon credit schemes give rise to accounting issues. However, we must note that NSS were not aware of the impact of these schemes on entities or considered that this is not relevant;

(d) Some jurisdictions identified diversity in practice and highlighted the need for IFRS guidance.

(e) Similar instruments, such as renewable energy certificates (RECs) are on the rise in Europe.

21 Besides the above initial outreach findings, other reasons to activate this project include:

(a) Connectivity: Addressing both accounting (i.e., recognition and measurement) and disclosure of PPMs could enhance the connectivity of financial statements and sustainability disclosures.

(b) Possible interaction with IASB intangibles project.

22 The EFRAG Secretariat is also of the view that the horizon scanning activities performed by the IABS staff seem to be appropriate and sufficient for the IASB to discuss whether a project on Pollutant Pricing Mechanisms should be prioritised.

Questions for EFRAG FR TEG-CFSS

23 Do you have comments or questions on the summary of the EFRAG Secretariat's response to the IASB's questionnaire?

24 Do you have any comments to be raised to the IASB on the horizon scanning activities performed by the IASB (see paragraph 5 above) and on the feedback collected by the IASB (see paragraph 6 above)?

25 Do you think the IASB should prioritise a project on pollutant pricing mechanisms? (taking into consideration the projects on the IASB's work plan and the project pipeline)

Agenda Papers

26 In addition to this cover note, agenda papers for this session are:

(a) Agenda paper 08-02 – [ASAF paper AP8 PPMs];

(b) Agenda paper 08-03 – [08-03 ASAF paper AP8A Pollutant Pricing Mechanisms Cover paper_ASAF_July];

(c) Agenda paper 08-04 – [08-04 ASAF paper AP8B Horizon scanning activities and feedback summary _ASAF_July];

(d) Agenda paper 08-05 -- [08-05 ASAF paper AP8C Summary of feedback NSS_ASAF_July]

(e) Agenda paper 08-06 – [08-06 ASAF paper AP8D Pollutant pricing mechanisms survey and questionnaire_ASAF_July]; and

Appendix 1: Overview of projects undertaken by other standard setters

US Financial Accounting Standards Board (FASB)

27 In May 2022, the FASB added to its technical agenda a project on the accounting for environmental credits programs. The project was initiated due to the lack of related guidance plus stakeholders' feedback indicated that environmental credits were gaining significance.

28 The objective of the project is to improve the recognition, measurement, presentation, and disclosure requirements for participants in compliance and voluntary programs that result in the creation of environmental credits and for creators of environmental credits. The FASB intends to publish an exposure draft in the second semester of 2024.

Definitions and scope

29 An environmental credit (EC) within the scope of the project is defined as an enforceable right that is acquired, internally generated, or granted by a regulatory agency that meets all of the following:

(a) lacks physical substance and does not meet the definition of a financial asset;

(b) represents the prevention, control, reduction or removal of emissions or other pollution;

(c) is separately transferable in an exchange transaction; and

(d) is not an income tax credit that can be used to settle an entity's income tax liability.

30 Renewable energy certificates (RECs), renewable identification numbers (RINs) and the European Union (EU) emission allowances are included in the project's scope while tax credits and additional payments entities make to become carbon neutral without a transfer of credits are not in scope.

31 Environmental credit obligations (ECO) within the scope of the project are obligations that arise from existing or enacted laws, statutes, or ordinances represented to prevent, control, reduce, or remove emissions or other pollution that may be settled with environmental credits. Therefore, obligations stemming from voluntary carbon neutral or net zero commitments are not ECO.

Asset recognition and measurement

32 <u>Mandatory carbon credit schemes</u> - an entity recognises an asset for an environmental credit when it is probable that the credit will be used to settle an ECO, or separately transferred in an exchange transaction. This was based on stakeholders' feedback that entities are usually aware of the specific use of the mandatory ECs they acquire or are granted. If it was probable an EC would be used to settle an ECO, the EC would be recognised at cost and not tested for impairment. In contrast, if it was not probable the EC would be used to settle an obligation, then the EC would be recognised at cost and tested for impairment.

33 <u>Voluntary carbon credit schemes</u> - purchased voluntary ECs would be expensed as it was not probable these ECs would be either used to settle an obligation or sold. As per the definition of assets in the FASB conceptual framework, voluntary ECs do not represent a present right to economic benefits for the reporting entity. To reach this conclusion, the

FASB analogised other accounting areas such as accounting for fixed assets not to be used in operations or sold, contributions, and advertising costs. Similarities to the latter arose when entities acquired ECs to mark themselves as being environmentally conscious. Under US generally accepted accounting principles (GAAP), advertising costs are generally treated as incurred expenses.

Liabilities

34 Entities recognise a liability when activities or events occurring on or before a balance sheet date indicate the existence of an ECO. The liability measurement is split into a funded and an unfunded portion. The funded portion of an ECO is measured based on the carrying amount of the ECs. The unfunded portion is generally measured using the fair value at the balance sheet date of the ECs necessary to settle the liability.

Presentation

35 An entity is prohibited from offsetting its ECO liabilities and associated compliance environmental credit assets.

Accounting Standards Board (AcSB)

36 The AcSB is conducting a research project on accounting for carbon offsets and credits. The related accounting issues are becoming more and more prevalent and material in Canada because it has a large oil and gas industry and there are multiple carbon credit schemes in place.

37 The identified accounting issues were as follows:

(a) Whether carbon credits meet the definition of an asset or whether they should be expensed.

(b) If they meet the definition of an asset, what ought to be their recognition and measurement requirements?

(c) What should be the recognition and measurement requirements for liabilities stemming from obligations that arise from the carbon credits?

(d) Acounting for the development of carbon credits that will ultimately be sold.

(e) Accounting for the development of carbon credits by a renewable energy generator.

(f) What is the unit of account?

(g) How does a company's business model impact the accounting for carbon offsets (i.e., what is their function in the carbon credit market)?

(h) Implications for emission reduction claims that were not achieved.

(i) Accounting for by-products where an entity may generate carbon credits at the same time it produces other products.

(j) Lack of linkage between assets and liabilities arising from carbon credits.

(k) Disclosures.

38 The following accounting standards are or could be applied for carbon credits:

(a) IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* - measurement at either fair value or nominal value could be applied for carbon credits arising from the compliance market.

(b) IAS 2 *Inventories* - in case the carbon credits are held for a company's ordinary course of business and they meet the definition of a broker/trader then IAS 2 would apply with measurement at either fair value less costs to sell or net realisable value.

(c) IAS 38 *Intangible Assets* – in case that carbon credits are not classified under IAS 2

(d) IFRS 9 *Financial Instruments* – limited application in Canada.

Group of Latin American Accounting Standard Setters (GLASS)

39 The representative of GLASS at the September 2023 IFASS meeting explained that Brazil had developed accounting guidance for carbon credits that was subject to public consultation. This was needed due to the transition of Brazil from a voluntary to a regulated market for carbon credits.

40 The guidance was related to an entity's business model. It considered three different types of holders of carbon credits, (a) the originator, which was an entity that controls economic resources that generate carbon offset and the intention to sell it; (b) the intermediary (broker and trader) that purchased carbon credits for purposes of selling (i.e., for trading purposes); and (c) the final user, which is an entity that acquired the carbon credits to offset its GHG emissions by retiring such instruments. The guidance also focused on disclosures, particularly in relation to the CapEx being invested to reduce emissions and OpEx for the purchase of carbon credits to offset own emissions.

41 The accounting guidance proposed the following accounting approaches:

(a) Asset classification holders of carbon credits: If the carbon credits are held for sale (e.g., by originators and intermediaries), the reporting entity should classify these carbon credits as inventory (i.e., be under the scope of IAS 2). If held for retirement; the carbon credits should be classified as inventory, i.e., by intermediaries, and by originators and final users where the carbon credit is considered an input to the production process. If not classified as inventory, carbon credits should be classified as intangibles (under IAS 38). They were of the view that according to the requirements of IAS 32 *Financial Instruments: Presentation*, carbon credits do not qualify to be classified as financial assets.

(b) Measurement basis- inventory: The appropriate measurement of carbon credits classified as inventory by originators due to either being held for sale or retirement is the lower of cost and net realisable value. For intermediaries, it is fair value less costs to sell if held for trading purposes, and the lower of cost and net realisable value if held for retirement. For final users, it is the lower of cost and net realisable value.

(c) Measurement basis- intangibles: Measured at a) cost less amortisation or reduction to the recoverable value by originators; and b) cost less impairment losses by final users.

(d) Liability recognition: a liability is recognised once there is a legal or self-committed obligation (similar to the example provided in the April 2023 IASB Staff where a company commits to offset future greenhouse gas emissions and if it takes actions that will require a transfer of economic resources a constructive obligation is created.

(e) Liability measurement: same as what was currently being done for other provisions, i.e., measurement is done using the best estimate assumptions.

Appendix 2: Previous IASB work on pollutant pricing mechanisms

42 The IFRS Interpretations Committee issued IFRIC 3 Emissions Rights in 2004, which was intended to address the accounting for cap-and-trade schemes. However, it was withdrawn in 2005 because IASB stakeholders raised concerns about the accounting mismatches that it created between the recognised assets and liabilities.

43 After the withdrawal of IFRIC 3, the IASB began a project on emissions trading schemes, again focusing on cap-and-trade schemes. Some tentative decisions were reached about what the assets and liabilities in the scheme were, when to recognise them, and how to measure them. However, the project was suspended in 2010 to allow the IASB to focus on higher-priority projects and complete its revision of the Conceptual Framework.

44 In 2014 IASB staff was allocated to start a research project on emissions trading schemes. In early 2015, the project was renamed pollutant pricing mechanisms to reflect the change in scope, approach, and direction of the project.

45 IASB staff carried out initial research to investigate the common economic characteristics of various pollutant pricing mechanisms and the accounting policies used to report them. The initial research identified interactions with the definition of a liability in the Conceptual Framework, particularly when entities received emissions allowances for free from scheme administrators. The research also identified questions about whether, and if so how, to recognise assets and liabilities arising from pollutant pricing mechanisms, some of which interacted with IFRIC 21 Levies.

46 Following feedback from the 2015 Agenda Consultation and a review of the research findings so far, the IASB suspended the project to focus on higher-priority projects.