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1. Brown v. Green, 654 F. Supp. 309, 314-315(E.D. Cal., 1968), rev'd, 437 F.2d 594 (9th Cir. 1969).
2. ID. at 202.
3. 15 U.S.C. § 104(STRONG).
4. See note 1 supra.

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# ACCOUNTING FOR THE PROPOSED CLEAN ENERGY AND SECURITY ACT EMISSIONS ALLOWANCES: ARE FAIR VALUES RELEVANT OR EVEN NECESSARY?

*Ramesh Narasimhan  
Shifei Chung\**

## **Introduction**

There is a lot of debate in the country about how to control for the climate change problems caused by the emissions of greenhouse gases (GHG) by companies. Since the introduction of the sulfur dioxide emissions program in 1995, the U.S. has been lagging in this area while the European Union has introduced an emissions trading scheme for GHG in 2005 to meet the member countries commitments under the Kyoto Protocol. Recently in the U.S. Congress the Clean Energy and Security Act (also known as the Waxman-Markey Act) was introduced in the House with the Senate to consider it later in the year or in 2010. This bill would require companies to control their total GHG emissions, similar to the European Union's (EU) emissions trading scheme (ETS). The bill proposes a "cap-and-trade" model similar to the one introduced in the sulfur dioxide program and this has led to a call for a comprehensive accounting standard on how to account for and disclose the effects of the program on affected companies' financial statements as the current generally accepted accounting principles (GAAPs) do not sufficiently address this area of accounting.

## **Background**

The first attempt to control for GHG emissions was the passage of the Clean Air Act in 1990 by the U.S. Subsequently in 1995 the sulfur dioxide emissions program was introduced by the Environmental Protection Agency (EPA). Under that program, the EPA allocated and auctioned allowance to regulated utilities to contain their sulfur dioxide emissions. Utilities were required to have sufficient allowances to meet their limits each year and if the allowances allocated by the EPA were insufficient compared to their actual emissions, the utilities were required to get allowances from others. This was the first use of the "cap-and-

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trade" scheme in controlling for emissions.<sup>1</sup>

In 2005 the Chicago Climate Exchange (CCX) was established by municipalities, government agencies, and prominent companies from different sectors in the U.S. and abroad. Members of the CCX committed voluntarily to reduce GHG emissions through a legally binding compliance program which was subject to a third-party verification. The program operated on a similar allowance scheme as the sulfur dioxide program with allocated annual emission allowances and the trading and purchase of excess allowances.<sup>2</sup>

In the same year the EU began its ETS with an objective to assist EU member countries to meet their commitments of carbon dioxide emissions under the Kyoto Protocol. This was set up as a cap-and-trade program where free allowances are provided by the EU to companies with goal of reducing the emissions each reporting period.<sup>3</sup>

Also in 2005, the Regional Greenhouse Gas Initiative (RGGI) was introduced by 10 states in the Northeast and Mid-Atlantic region of U.S. to specifically target GHG emissions by power plants in this region. This is a mandatory cap-and-trade program with the goal of reducing GHG emissions by 10% by 2018. Similar to the RGGI, the Western Climate Initiative was introduced in 2007 to reduce GHG emissions in seven western states in the U.S. and four Canadian provinces.<sup>4</sup>

#### **Accounting for Cap-and-Trade Allowance under U.S. GAAPs**

Since the sulfur dioxide program of 1995 affected only companies in the regulated energy sector, the Federal Energy Regulatory Commission (FERC) rules does apply to the accounting of these emission allowances received from the EPA. The FERC rules require accounting for the initial acquisition of allowances at historical cost in inventory, thus only purchased allowances are accounted for in the financial statements as allowances received from the EPA are free and hence have no cost basis. The expenses recognized in the income statement periodically are based on the weighted-average cost method.

There is no official standard issued by the Financial Accounting Standards Board (FASB) that addresses the accounting for emission allowances. The Emerging Issues Task Force of the FASB initially addressed this in their Issue no. 03-14, *Participants' Accounting for Emissions Allowances under a "Cap and Trade" Program* in November 2003 but subsequently decided to withdraw it from their agenda. Recently the FASB announced that it is working on a comprehensive emissions allowance accounting project in conjunction with the IASB.

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<sup>1</sup> Fornaro, J., Winkelman, K., & Glodstein, D., "Accounting for Emissions", *Journal of Accountancy*, 208(1), 40-45 (2009).

<sup>2</sup> Crosman, P., "Trading For A Cleaner Tomorrow", *Wall Street & Technology*, 27(5), 30 (July 2009).

<sup>3</sup> See note 1 supra.

<sup>4</sup> Deloitte Touche Tohmatsu, "Business Implications of the Developing North American Carbon Market: Confronting the Carbon Challenge", Deloitte Touche Tohmatsu, (April 15 2009).

### Accounting for Cap-and-Trade Allowances under IFRS

Despite the fact that emissions trading scheme has been active since 2005, there is no official IFRS standard applicable to this area. In December 2004, the International Financial Reporting Interpretations Committee (IFRIC) of the IASB issued IFRIC 3 *Emission Rights*, summarizing what accounting treatments should be followed by the participants of the EU's ETS. IFRIC 3 concluded that emission allowances were intangible assets and should be accounted for under IAS 38 Intangible Assets, which permits either the historical cost model or fair value treatment. If the fair value treatment were adopted, increases in fair value were to be reported in stockholders' equity and decreases in fair values would be recognized in profit and loss if they exceeded the revaluation surplus. The difference between the price paid and fair value of allowances received from the government would follow IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*. The difference was to be initially reported as deferred income (a liability) and then recognized as revenue over the compliance period systematically. The recognition of a liability and expense for actual emissions would follow the guidance in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.<sup>5</sup> However, following criticisms by companies and governments in the EU, the IFRIC withdrew IFRIC 3 within six months of its issuance, and the IASB does not have any pronouncements as yet that deal directly with the accounting of emissions allowances. Since the emissions trading scheme (ETS) is already operational, accounting for the emission allowances has been very diverse as evidenced by the survey done by PricewaterhouseCoopers in 2007.<sup>6</sup>

### Are Fair Values Relevant for the Proposed Act?

Since the passage of the Clean Energy and Security Act is considered very likely later this year or in 2010, it is apparent that the FASB needs to come up with a proposed standard soon. The main issue that needs to be resolved would be which approach should the proposed standard take — the historical cost model as followed by the FERC for sulfur dioxide emissions, or the fair value treatment as prescribed in IFRIC 3. If the proposed act follows the scheme used by the EPA in 1995, then emission allowances will be given to companies free of charge. Under the historical cost model, thus only the purchased allowances would be accounted for and this cost would be allocated to expense as the emissions occur with a corresponding reduction in the "inventory" of allowances.

Whereas in the fair value model, initial acquisitions of allowances would be recorded at fair values with a credit to deferred revenue. Expenses would be

<sup>5</sup> Lothar, J and K. Swarbrick, "Accounting for the European Union Greenhouse Gas Emissions Trading Scheme", [www.doh.gov.uk/doh/finman.nsf](http://www.doh.gov.uk/doh/finman.nsf), (2009).

<sup>6</sup> PricewaterhouseCoopers, "Trouble-Entry Accounting—Revisited: Uncertainty in accounting for the EU Emissions Trading Scheme and Certified Emission Reductions", PricewaterhouseCoopers, (2007).

recognized from the allowances as the emissions occur while correspondingly revenues would be recognized from the deferred revenues. Any purchase of allowances would be recognized at the time of purchase at cost and the remaining balance at year-end would be revalued at fair values with a corresponding recognition of a gain or loss in the income statement. Unallocated allowances would be shown at their fair values as an intangible asset in the balance sheet.

Under both methods, the emissions allowances are considered assets, either inventory in the cost model or intangible assets in the fair value model. The question is, do the allowances really meet the criteria to be recognized as assets? Some would argue that the emissions allowances give income-generating benefits to the company in the future, either through the utilization of the production facilities for income-generating activities or through the sale of excess allowances to other companies in the cap-and-trade scheme. On one hand, one could argue that while the emissions allowances are necessary for operations, they are essentially a permit to operate given by the federal government. Unlike plant assets or even some intangible assets, this allowance is not separately obtainable from other sources in order to operate. It is a necessary condition to operate, much like permits. On the other hand, the presence of the cap-and-trade scheme seems to imply that there is a market for these allowances, suggesting the notion of an asset. However, for companies, not all of the allowances are tradable commodities — only the allowances considered in excess of the actual required for operations would be tradable. This would be contingent on the actual production processes of the company in the future period, which makes this more a contingency than an asset.

Based on the above reasoning, three possible scenarios would exist for a company — the allowances received are exactly equal to the GHG emissions for the period, or the allowances are more or less than the actual emissions. If the allowances are more, the excess could be traded away or carried forward to meet demands for actual emissions next period. If the allowances are less, the deficit would need to be purchased in the market to ensure compliance with the program. Thus the accounting issue basically becomes accounting for contingencies whereby either a contingent asset and a corresponding gain occurs, or a contingent liability and a corresponding loss occurs. Under the current U.S. GAAPs, only a contingent liability and loss would be recognized while the contingent gain would not be recognized until the actual event. Therefore, we would argue that accounting for emissions allowances is essentially accounting for contingencies and hence a fair value treatment would unnecessarily distort both the income stream and the financial position of a company if adopted.

Some would argue that the purchase or sale of forward contracts for emissions allowances makes it similar to an asset item rather than a contingency. However, the purchase or sale of forward contracts for emissions allowances is a hedging strategy that is completely independent of the accounting for emissions allowances. Thus the accounting for these contracts would remain the same basis as any other hedging activity which is already covered under existing accounting rules.

The fact that some companies choose to adopt a hedging strategy to minimize the potential cost of purchasing additional allowances or maximize the potential sale of excess allowances is independent of the acquisition of allowance from EPA or other regulatory authorities.

Similarly, the argument that SFAS 153 fair-value rules should be applied to the sale and purchase of excess allowances would only hold true if the allowances are recorded as assets initially. As we have argued, the initial free acquisition of allowances does not really constitute an asset acquisition, but rather a permit to operate and hence the exchange of excess allowances does not really constitute an exchange of assets.

### **Conclusions**

With the imminent passage of the Waxman-Markey act, the need for a comprehensive accounting standard for emissions allowances is unquestionable. The FASB has a choice of adopting rules based on the historic cost model or the fair value treatment. We recommend that the FASB address this issue more in line with a recognition of a contingency rather than an acquisition of an asset given that only the excess amounts of the allowances over the amounts required to operate are tradable by the companies. Since rules already exist for accounting for contingencies, any application of the fair value treatment, in our opinion, introduces fluctuations in the income stream and in the balance sheets of companies, thus making it more difficult for users of financial statements to get a clear understanding of the financial position of companies subject to emission accounting rules.