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Emission-related schemes and related accounting guidance in Japan

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I. Chronology

- **November 2004:** The ASBJ published its accounting guidance responding to emerging voluntary emission trading transactions relevant in Japan.
- **February 2005:** Kyoto Protocol came into effect. The Ministry of Environment introduced the Japan's Voluntary Emissions Trading Scheme (JVETS).
- **October 2008:** *Experimental Emission Trading Scheme* (a nation-wide voluntary scheme) was introduced.
- **June 2009**: The ASBJ revised its accounting guidance to clarify the accounting requirements relevant to trading under the national voluntary trading scheme.
- **April 2010:** *Tokyo Cap-and-Trade Program* (a prefectural mandatory scheme) was launched.
- **April 2011:** *Saitama Cap-and-Trade Program* (a prefectural mandatory scheme) was launched.

(Note) The ASBJ has not revised its guidance, in response to introduction of *Tokyo / Saitama Cap-and-Trade Programs*.

II. Emission Trading Schemes in Japan (1/2)

Experimental Emission Trading Scheme

- **Nature**: A nation-wide voluntary scheme aimed at reduction of CO2 emissions (An entity has an option to participate in the scheme.)
- **Compliance periods**: All or part of the period from the year 2008 to 2012 (Now positioned as part of the JVETS)
- **Target reduction**: An entity sets its own target reduction in the period, subject to review and confirmation by the government.
- **Banking/Borrowing**: An entity is permitted to apply 'banking' or 'borrowing' when there is a surplus or shortage of emission allowances at the end of the target period.
- **Emission trading**: An entity is permitted to enter into emission trading before the end of target periods. An entity can choose the scheme similar to Cap and Trade scheme or Baseline-and Credit scheme. However, even when Cap and Trade scheme is chosen, an entity is prohibited from selling emission allowances equivalent to 90% of allotted allowances.
- **Penalties**: There is no formal sanction against an entity failing to accomplish the target reduction.

II. Emission Trading Schemes in Japan (2/2)

Tokyo/ Saitama Cap-and-Trade Programs

- **Nature**: Prefectural mandatory schemes aimed at reduction of CO_2 emissions
- **Compliance periods**: 1^{st} compliance period: As for Tokyo Program, FY2010-FY2014 and 2^{nd} compliance period: FY 2015-2019
- **Target reduction**: 6-8% reductions for the 1^{st} compliance period
- **Banking / Borrowing**: An entity is permitted to apply 'banking' when there is a surplus of emission allowances at the end of the target period. However, 'borrowing' is not permitted.
- **Emission trading**: From the second year of each compliance period, reductions in excess of annual obligations may be traded as credits, subject to a limit of one-half of base year emissions (Unlike, simple Cap and Trade schemes, not all allowances can be traded before the end of the compliance period. In addition, it has been observed that trading is relatively inactive in markets.)
- **Penalties** (Tokyo Program only): Surcharge on reduction obligation of 1.3 times the shortfall is imposed, if an entity does not accomplish the target reduction. Ultimately, fines of up to JPY 500,000 is imposed for non-compliance.

III. Accounting Guidance in Japan (1/4)

Scope

- The guidance addresses the schemes that existed in Japan, when it was published.
  - ✓ The guidance does not cover the situation where an entity has an obligation to reduce the amount of GHG emission.

Nature of Emission Credits

- The emission credit is not a legal property right, but is akin to the ‘intangible asset’
  - ✓ It is not a financial asset, because the holder of the emission credit does not have a contractual right to receive a cash.

III. Accounting Guidance in Japan (2/4)

Basic concepts

- Broadly, an entity’s investment can be classified into the following categories:
  - ✓ Financial investment: An investment which an entity holds for the purpose of making profits from price changes, and there is a market in which the investment can be transferred to third parties. Also, there is no restriction for an entity to sell the investment in the course of its business operation.
  - ✓ Business investment: An investment which an entity holds for the purpose of acquiring cash as a result of business (rather than solely as a result of the investment’s price changes), and there is a restriction for an entity to sell the investment.

Classification of Emission Credits

- Emission credits can be classified, depending on the holding purpose of an asset:
  - ✓ Held for sales
  - ✓ Held for an entity’s own use

III. Accounting Guidance in Japan (3/4)

Emission Credits held for sales to third parties

- When an entity purchases emission credits solely for the purpose of sales to third parties, they should be accounted in a manner similar to purchases of commodities:
  - ✓ An entity recognizes the asset as an inventory at costs, when the credit is transferred to an entity.
  - ✓ An entity measures the asset at the lower of costs or net realizable value.

Emission Credits held for an entity's own use

- When an entity purchases emission credits for the purpose of its own use, they should be accounted for as a purchase of 'intangible assets' or 'other fixed assets.'
  - ✓ An entity measures the asset at costs, subject to review for impairment.
  - ✓ The amount recognized as an asset is reduced and the corresponding amount is recognized as an expense, when:
    - The credit is used for an entity's own emission reduction;
    - It becomes certain that an entity will use the credit for its own use; or
    - It becomes impossible that an entity will sell the credit to third parties.

III. Accounting Guidance in Japan (4/4)

Emission Credits held for an entity's own use

- An entity does not recognize an asset or a liability, when emission allowances are granted by the government:
  - ✓ There is no journal entry, when emission allowances are granted by the government.
  - ✓ When an entity sells part of the emission allowance granted by the government during the compliance period, the consideration received is recognized in the suspense account (for the credit side).
  - ✓ The suspense account is reclassified to profit, when it becomes certain that an entity will accomplish the target emission reduction throughout the compliance period in the context of the emission-related scheme.
  - ✓ If an entity has emission allowances purchased from third parties and ones granted by the government, the emission trades are accounted for on the assumption that the purchased allowance is sold first.

(Note) The guidance does not anticipate the situation where an entity holds emission credits solely for the purpose of sales to third parties, when emission allowances are granted by the government.

IV. Comparison between ASBJ's guidance and Approach 3 (Assets)

Items	Details	IASB Staff Paper Approach 3	ASBJ Guidance For sales to third parties	ASBJ Guidance For an entity's own use
Initial recognition	Allocated allowances	No journal entry	N/A	No journal entry
	Purchased allowances	Recognize and measure at cost	Recognize as an 'inventory' and measure at cost	Recognize as an 'intangible asset' or 'other fixed asset' and measure at cost
Subsequent measurement	Of government grant	No journal entry	N/A	No journal entry
	Of allowances	Measure an asset at cost, subject to review for impairment	Measure an asset at the lower of cost or net realizable value	Measure an asset at cost, subject to review for impairment
Derecognition	-	-	Account for sales of inventory, and recognize the corresponding amount as expenses	Recognize the amount corresponding to an entity's use as expenses

IV. Comparison between ASBJ's guidance and Approach 3 (Liabilities)

Items	IASB Staff Paper Approach 3	ASBJ Guidance For sales to third parties	ASBJ Guidance For an entity's own use
Recognition	No liability is recognized until emissions produced exceed the allowances allocated to the participants.	N/A	N/A (except for 'suspense account')
Measurement	Liability is measured based on: (a) <u>The carrying amount of allowances on hand</u> at each period end to be used to cover actual emissions on a FIFO or weighted average basis; plus **(b)** **<u>The market value</u>** of allowances at each period end that would be required to cover <u>any **excess emissions**</u>**.**	N/A	N/A (except for 'suspense account')

(Note) The ASBJ's guidance does not address the situation where a penalty is imposed on an entity when an entity does not accomplish the target during the compliance period.

Thank you!