# GIFTED POLLUTION ALLOWANCES: RECOGNIZING A LIABILITY TO SOCIETY

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## ABSTRACT

Air pollution is of increasing global concern and will continue to be as long as fossil fuels continue to serve as a primary source of energy for the generation of electric power. In an effort to reduce atmospheric sulphur dioxide, a major precursor of acid rain in the United States, the Clean Air Act Amendments of 1990 created a system of tradable pollution permits under which electric utilities are annually gifted a fixed number of allowances that permit them to emit sulphur dioxide into the atmosphere or to sell unneeded permits in a free market setting.
Regardless of whether or not one endorses the use of pollution allowances as desirable, or even legitimate, the accounting profession must deal with the accounting and reporting issues raised by the use of these allowances in a manner that is both theoretically sound and that maintains the integrity of the financial accounting and reporting model. While the accounting for *purchased permits* is relatively clear, the accounting for *gifted permits* is an important, but currently controversial and unresolved issue. In this paper, we examine the financial statement issues related to gifted pollution allowances within the context of the Financial Accounting Standard Board's Conceptual Framework and find that it provides unequivocal support for recording gifted permits as assets and liabilities (to society). We then examine alternative means by which a utility could extinguish its liability and present an illustration of the actual accounting entries under various regulatory and market scenarios.

Ideally, externalities should be considered in the determination of the cost of products and services (i.e., by implementing full cost accounting) and, ultimately, reflected in prices to consumers. Accordingly, in the case of electric power, the costs associated with the consumption of gifted allowances to compensate for emissions or, alternatively, the cost of investment in pollution prevention to eliminate emissions, should be borne by the consumer. Requiring financial statement recognition of gifted pollution allowances as assets and liabilities should increase the probability that externalities are factored into managerial, regulatory and investment decisions and would result in increased comparability and consistency in financial accounting among reporting entities. We conclude that if society realistically expects management and stakeholder decisions to be influenced by environmental externalities, electric utility companies must be required to explicitly account for gifted pollution allowances as liabilities.