EFRAG
European Financial Reporting Advisory Group

Dr. Alexander Schaub
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

Dear Dr. Schaub,

DRAFT FOR COMMENTS BY NO LATER THAN 22 March 2005

Re: Draft on negative endorsement on IFRIC 3 *Emission Rights*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of International Accounting Standards we are pleased to provide our opinion on the adoption of IFRIC 3 *Emission Rights* as published by the IFRIC on 2 December 2004 based on IFRIC D1.

The main features of IFRIC 3 are:

- The objective is to provide guidance on accounting for a cap and trade emission right scheme that is operational.
- A cap and trade scheme gives rise to: a) assets for allowances held, b) a government grant and c) a liability for the obligation to deliver allowances equal to emissions that have been made.
- Allowances are intangible assets that are accounted for in accordance with IAS 38 and, if issued for less than their fair value, they are measured initially at their fair value.
- When allowances are issued for less than their fair value, the difference between the amount paid for them and their fair value is a government grant that is within the scope of IAS 20.
- As emissions are made, a liability is recognised for the obligation to deliver allowances equal to emissions that have been made.
- That liability is a provision and is accounted for in accordance with IAS 37. It shall be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. This will usually be the current market price of the allowances.
- If there is any indication that the allowances may be impaired, they must be tested for impairment in accordance with IAS 36.

EFRAG has evaluated IFRIC 3 based on input from standard setters and market participants in accordance with EFRAG's due process.

EFRAG is supportive of the objective of IFRIC 3 to provide guidance on accounting for a cap and trade emission right scheme. We agree with the IFRIC that a cap and trade scheme gives rise to an asset (for allowances held), a government grant (if the allowances are issued for less than their fair value) and a liability (when emissions are made). However, EFRAG has concerns about the overall effect of the accounting requirements in IFRIC 3, particularly in circumstances where entities have not acquired or sold allowances. EFRAG believes that applying IFRIC 3 will not always result in economic reality being reflected and relevant information being provided. That is because the accounting in IFRIC 3 is constrained by the interplay of the existing standards IAS 38 *Intangible Assets*, IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

The interplay creates a measurement mismatch (whereby some items are measured at cost (IAS 38 and IAS 20) and others at fair value (IAS 37)) and a reporting mismatch (whereby some gains and losses are reported in profit or loss (IAS 37 and IAS 20) and others in equity (IAS 38)). These accounting mismatches are all the more critical because there is an economic interdependency between the assets and liability involved in the scheme: emission rights are granted to allow entities to settle their liability for emissions made up to an authorized level; and emission rights are the only assets eligible for settlement of the liability for emissions made.
Because of this EFRAG is of the opinion that the resulting financial information does not always faithfully reflect economic reality.

EFRAG's main concerns can be summarised as follows:

(a) Under the cost model described in IFRIC 3, the allowances at hand are measured at cost and the corresponding liability at fair value. When the market price of the allowances changes, the income statement may be affected by a mismatch that is created by the mixed measurement model. We believe that this accounting mismatch is artificial and does not faithfully represent economic reality particularly in cases where the entity does not trade.

(b) Under the revaluation model described in IFRIC 3, there is no mismatch as regards the value of the allowances and the liability in the balance sheet at year-end. However, there is a mismatch in relation to the income statement, both during the interim periods and at year-end, because revaluation gains are recognised directly in equity while expenses relating to the liability are recognised in profit or loss. We are concerned that this will result in information that is not relevant for the users.

(c) Further EFRAG is concerned about the accounting when the compliance period is finished because under IFRIC 3 the measurement of the asset (the allowances) and the liabilities (the provision) must be continued and the mismatch indicated above will continue to exist even though the compliance period is over until the liability is extinguished via settlement. EFRAG challenges whether it is in accordance with the standards that enterprises are not allowed to calculate the result of the scheme at the end of the compliance period and take the net effect to the income statement.

DRAFT EFRAG conclusion

EFRAG has concluded that the disadvantages that would arise from endorsing an interpretation constrained by the interplay of the current IFRSs/IASs are not outweighed by the advantages that would be gained by having guidance on the accounting on the emission right schemes.

EFRAG believes that application of IFRIC 3 does not result in relevant financial information because that information will not faithfully represent the economic reality.

EFRAG has therefore concluded that IFRIC 3 does not meet all of the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards because:

i. it is contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
ii. it does not meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, we believe that it is not in the European interest to adopt IFRIC 3 in its present form. EFRAG therefore recommends the EU Commission not to endorse IFRIC 3 *Emission Rights.*

The IFRIC is reconsidering the interpretation to improve the accounting quality of the financial information resulting from IFRIC 3. EFRAG will cooperate with the IFRIC and will participate in the due process if IFRIC proposes amendments to IFRIC 3. An amended IFRIC 3 again needs to be evaluated for endorsement in Europe against the existing criteria of the Regulation.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman

Basis for conclusions:

1. In our comment letter to the IFRIC dated 25 July 2003 on IFRIC D1 *Emission Rights* we recommended the IFRIC to consider an accounting model in which the obtaining and use of emission rights should be as linked transactions. As a result, the rights obtained would be amortised on a systematic basis and the entity would only recognise an emission liability when it pollutes more than allowed under its rights held.

   The IFRIC did not consider this approach in the final interpretation as they argue that an allowance meets the definition of an asset in the framework; the obligation to deliver allowances meets the definition of a liability and the asset and liability exist independently.

   We are convinced by the arguments put forward by the IFRIC and agree there should be no offset between assets and liabilities.

2. EFRAG has discussed whether based on elimination of the option in paragraph 23 of IAS 20 it can be concluded that the interpretation is not in line with existing standards. Paragraph 23 allows recording both, assets (the allowances) and the government grant, at nominal value. However, EFRAG is convinced that the objective of an interpretation is to interpret existing standards in relation to a specific issue and that an interpretation can still be in line with existing standards even though that it eliminates existing options.

3. We agree with IFRIC that a liability arises when emissions are made. However IFRIC is of the opinion that this liability should be accounted for as a provision in accordance with IAS 37 and specifies that the obligation to deliver allowances for past emissions will normally be measured at the present market price. EFRAG questions whether IFRIC's conclusion is in line with the existing standards and challenges whether the liability meets the definition of a provision in the scope of IAS 37. The reason is that there is in our opinion no uncertainty about either the timing or the amount when the emissions are made. The liability is in our opinion not uncertain in timing as the compliance period and settlement date is fixed. Nor is the liability uncertain in amount as the amount of pollutant is the direct quantitative number of emissions made at the existing market price. Regardless whether it meets the definition of a provision or not we can live with the interpretation in this respect.

4. EFRAG agrees with the IFRIC that the schemes result in assets and liabilities which should be measured independently, but EFRAG believes that the approach taken in IFRIC 3 is constrained by the interplay between the existing standards (IASs 38, 20 and 37). EFRAG believes that the application of IFRIC 3 results in an artificial mismatch and therefore in information which is not relevant for users.

5. In relation to the cost model EFRAG's main concern relates to the overall effect of the accounting; that is, the combined effect of IFRIC 3's accounting requirements for assets and liabilities on the income statement. EFRAG disagrees with the use of different measurement bases for measurement of the assets and the liability. Because participants can only extinguish the liability by handing in allowances to the authorities—it cannot be settled with other assets, e.g. cash—it seems illogical to us that the liability is measured at an amount different from the assets held to extinguish the liability.

   This mismatch under the cost model appears not only in the interim financial statements, but also in the annual results as it is only to be eliminated at the settlement date. We believe that explaining the mismatch in the management report would not provide sufficient transparency and understanding of the financial statements as in some industries it may have a significant impact on the financial results.

   The cost model is the benchmark treatment in IAS 38; however we believe that application of this model should be limited to circumstances where no effective market for the allowances exists.

6. Under the revaluation model both the allowances and the liability are measured at fair value. However IAS 38 requires revaluation gains on the assets to be recognised directly in equity and not in profit or loss, whilst IAS 37 requires changes in the liability to be recognised in profit or loss. To reflect economic reality and provide relevant information to users, both the gains and the losses should be required to be recognised in profit and loss.

7. Further EFRAG is concerned that the accounting mismatch continues to exist even beyond the compliance period. The illustrative examples in IFRIC 3 show clearly that, when applying the cost model, the mismatch is only eliminated when the liability is settled and not at the end of the compliance period. This is again caused by the different measurement basis for assets and liabilities.

   Under the revaluation model, the mismatch runs beyond the end of the compliance period because it is not permissible to bring the revaluation of the allowances and the restatement of the liability together in the income statement at the end of the compliance period. This would be solved in relation to the revaluation model if IAS 38 were to be amended to require all fair value adjustments of allowances to be taken to profit and loss.

   EFRAG challenges whether it is in accordance with the standards that enterprises are not allowed to calculate the result of the scheme at the end of the compliance period and take the net effect to the income statement. This is not spelled out in the interpretation itself, but only in the illustrative examples.

8. If the enterprises were allowed to calculate the result of the scheme at the end of the compliance period, the effect of trading and/or settlements differences due to movements in prices after the end of the scheme would be reflected in the year(s) after the end of the compliance period. Such a treatment would be consistent with the accounting in other cases under existing standards. EFRAG believes that the mismatch created by the accounting requirements of IFRIC 3 will have a significant impact on reported financial results in certain industries but will not always reflect economic reality. Therefore we have concluded that the accounting proposed by IFRIC 3 does not provide relevant information for users because it does not faithfully represent the economic reality. For that reason, we do not recommend the European Commission to endorse IFRIC 3.

9. The IFRIC is having another look at the interpretation with a view to improving the accounting. It has proposed to IASB that a subset of intangible assets that includes emissions allowances should be identified and that a new accounting treatment in IAS 38 should be specified requiring remeasurement at fair value with the resulting gain and loss being recognised in profit or loss. The IFRIC observed that an emission allowance is a form of currency, because the allowances are fungible and there is a mechanism for exchanging values between parties. The allowances differ from other intangible assets because the participants can only extinguish the liability by handing in these allowances. The allowances cannot be used for anything other than trading or settlement. We are supportive of this new approach. However, we are aware that, under a revaluation model, allowing remeasurement of the allowances at fair value with the resulting gain or loss recognised in profit or loss will not solve the mismatch in its entirety; if allowances are measured at their fair value, interim results may still be affected by changes of prices if the number of allowances held is higher than emissions made. The fair value adjustments will then exceed the decrease/increase in expense to be recognised. However, we believe that these are in reality fair value adjustments of assets that should be recognised in profit and loss.

   Furthermore we are aware that the IASB has plans to amend IAS 20 to preclude the recognition of deferred credits. However at present it is not possible to foresee the consequences of the amendments to IAS 20 and the consequential amendments to IFRIC 3.

EFRAG is co-operating with the IFRIC and has forwarded proposals for consideration to it. EFRAG will participate in the due process if the IFRIC proposes amendments to IFRIC 3. An amended IFRIC 3 will need to be evaluated again for endorsement in Europe against the existing criteria of the Regulation.

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