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Françoise Flores, Chair
European Financial Reporting Advisory Group (EFRAG)
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Dear Ms Flores,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, we appreciate the opportunity to comment on EFRAG's Draft Comment Paper (DCP) *Emissions Trading Schemes*.

Principal authors of this comment letter were Max Eibensteiner, Christian Höllerschmid and Gerhard Prachner. The professional background of the authors is heterogeneous (one auditor and two preparers), in order to assure a balanced Austrian view on the DCP.

GENERAL REMARKS

Since the implementation of the EU Cap and Trade Scheme and the withdrawal of IFRIC 3 in 2005, diversity in practice in the accounting treatment of emission rights has arisen. As the range of companies covered by the scheme is likely to be enlarged rather than reduced in coming years, clarification of this issue will become more urgent. The IASB has recently published its future working program based on the responses to its agenda outreach activities, and puts a solution to the issues addressed in this DP as one of the top priorities once major existing projects are concluded. We therefore support EFRAG's efforts to propose a possible solution early in the process.

SPECIFIC REMARKS

Para. 28 Do you agree that specific accounting guidance is needed? Please explain why.

We agree. Since the withdrawal of IFRIC 3 by the IASB, accounting for emission rights has been unregulated, and divergent practices have developed. In particular, the accounting treatment of free allowances allocated by public authorities needs attention and an unambiguous solution. In addition to initial recognition and measurement, subsequent accounting procedures are of particular importance in the light of the accrual principle established in the IASB Conceptual Framework.

Para. 29 Do you agree with the arguments presented above? Should any other arguments be included?

Although there is no direct guidance under existing IFRSs as to where emission rights should be recognised in the statement of financial position (under intangible assets, inventories or financial assets), we think there are strong arguments supporting the recognition of emission rights as intangible assets. These rights are:

- identifiable,
 - separable (as the allowances can be sold),
 - legal rights (as the allowance is a “licence to pollute“),
- they have no physical substance, and
- they prevent cash outflows (by avoiding penalties). This last argument suggests that they are goods “from which future economic benefits are expected to flow to the entity” and hence assets.

When accounting for emission rights as intangible assets, the measurement method should be explicitly stipulated, because simply referring to IAS 38 would allow diversity in practice, as the standard permits two different approaches (cost method or revaluation method). Permitting the use of the revaluation method would create additional complexity, as the question of subsequent recycling of the revaluation amounts would have to be addressed. In our view, therefore, the cost method less impairment should be the only one permitted.

If the cost model is to be applied, potential impairment must also be covered. How the related deferred income (question in para. 70) would be affected by impairment of the allowances, if at all, is a particularly interesting question. On the basis of the sample calculation in Appendix A, we conclude that the deferred income would be linked to the production process (and the emissions produced) rather than to the allowances themselves, so that it would not be affected by impairment

of the related asset.

Para. 39 Do you agree with the analysis of information needs of users for each business model?

In principle we agree, although it might be difficult to distinguish between trading and compliance portfolios before the fact. However, the reporting entity's past behaviour could be used as a basis. We believe also that the mix of volumes (allowances actually held, expected allowances for the compliance period, and hedged volumes) would provide sufficient information about the position (short/long) of the reporting entity at the reporting date. Information on capital expenditure related to pollution reduction is of minor importance, and would only provide additional insight for a limited group of users, such as technical experts able to judge the probable impact of a specific investment.

Para. 40 Do you agree that this should result in different accounting requirements?

We agree. Rights held for compliance purposes serve to control production costs, whereas those held for trading are acquired for short-term profit. A trader's risk is significantly higher than that of an entity that surrenders the allowances to the public authorities at the end of the period. The trader needs rising prices to realise gains, while an entity merely interested in complying wants prices to stay as low as possible. Once purchased, the value of the allowances is of minor importance to a complier, it is rather the emission volumes covered that are important.

Para. 56 Do you agree that free allowances should be measured at fair value at inception, this fair value being their deemed cost?

We agree. Because we believe that emission allowances are intangible assets in the meaning of IAS 38, we think they should be shown as part of the reporting entity's statement of financial position. As there is a highly liquid market for these assets, there is no reason why the market price should not correctly determine the fair value.

Para. 70 Which of the above options would you support? Please explain why?

In our view, free allowances represent public support to reduce the burden on carbon-dioxide emitters. This support is thus comparable to public subsidies for property, plant and equipment that protects the environment, such as particle filters or machinery for pre-treatment of waste to reduce landfill volumes. Similar accounting procedures to those applied for government grants would therefore seem appropriate, with the credit side of the free allowances shown as part of deferred income and released over the period of the actual emissions.

Showing a deferral from free allowances as other comprehensive income (OCI) would definitely not contribute to a true and fair view, because the entity's net assets and equity are not increased when the rights are granted but only as and when they are used in the production process or sold. The tendency to assign items to OCI simply because no agreement could be reached on more specific recognition in the income statement or the statement of financial position should be resisted.

Para. 76 Do you agree that in a compliance model an entity should not offset the asset and the liability, because separate presentation provides more relevant information?

We agree. Offsetting under IAS 32 would require the existence of a financial asset and a financial liability. As argued above, emission allowances are intangible assets, and therefore not within the scope of IAS 32. The allowances and the obligations, although related, follow different logics and have different causes: the former are acquired or disposed of as the entity decides and can be traded or held for compliance purposes, while the latter are wholly dependent on the emissions produced.

Para. 77 Do you agree that the liability should not be derecognised before the entity surrenders the rights to the Regulator (i.e. surrendering rights affects the entity's financial position and is not solely a compliance exercise)?

We agree. Both from a legal and from an economic point of view, the liability is extinguished only when the underlying obligation is discharged, that is, when the entity surrenders the allowances or the creditor (the Regulator) waives the liability (which is highly unlikely).

Par. 78 – Do you agree that the entity's value changes with the act of emitting and that settling the obligation to the Regulator has economic value? Do you agree that balance sheet information has economic value to users?

The act of emitting creates an obligation that the entity has to meet by surrendering the corresponding number of allowances, or otherwise paying a fine. The act of emitting therefore reduces the value of the entity, and discharging the obligation correspondingly increases the value. Disclosing assets and liabilities related to emission trading schemes enhances the information content of the statement of financial position.

Para. 88 Do you agree or disagree with EFRAG's proposal on the subsequent measurement of assets and liabilities? Please explain why?

Basically, we agree. The proposed method most closely aligns the recognition of net production

costs with the accrual principle in IASB's Conceptual Framework. From the preparer's perspective, the calculations are fairly straightforward, and implementation will not involve undue efforts and cost.

Para. 102 Which of the above alternatives would you support? Please explain why.

AFRAC supports the 'own use exemption' alternative. The issue is when the own use exemption for derivatives (forward contracts) should be lost. From the entity's point of view, the basic purpose of entering into such a contract is to cap and fix production costs. The crucial factor in this context is how much of the expected emissions is covered by the derivatives. If the contracted volumes together with available allowances match the expected emissions, there is a reasonable expectation that the derivatives are being held for compliance purposes. If some of the allowances are sold because the entity's emissions were lower than expected, the entity should not lose the own use exemption provided the final volume of allowances does not differ materially from the volume held after the transaction. As the EU cap and trade scheme has been in force for some time, entities should by now have reliable knowledge about their emission volumes. A large, recurring gap between initially estimated and actual volumes would lead to the conclusion that at least a part of the portfolio is used for trading purposes and should be separated from the compliance portfolio.

Par. 107 – Which of the above alternative approaches would you prefer and why?

Since the EU cap and trade scheme has been in force for some time, in our view the issues are clear, and no more research activities are justified. What is needed is specific guidance in form of a separate Standard for emission trading schemes – interpretation under existing Standards has already been tried, with only limited success. Interpretation also runs the risk of allowing alternative treatments (e.g., under IAS 38 or IAS 20) which would result in diverging practices again.

Appendix A

With reference to the accounting example in Appendix A, if expected emissions are smaller than the number of free allowances granted, the release of deferred income (linked to expected emissions) to profit and loss could result in negative production costs as the amount of released deferred income would exceed the cost of actual emissions.

Kind regards,

Romuald Bertl

Chairman