

EMISSION TRADING SCHEMES

EFRAG

Feedback Statement on Comment Paper

October 2013

© 2013 European Financial Reporting Advisory Group.

The document is issued by the European Financial Reporting Advisory Group (EFRAG)

The purpose of this feedback statement is to provide an overview of the key points made by respondents to the Comment Paper (DP), 'Emission Trading Schemes'.

Table of contents

INTRODUCTION.....	4
Objective.....	4
Level of response to the comment paper	4
EXECUTIVE SUMMARY	4
SUMMARY OF RESPONSES	5
Is there a need for specific accounting guidance on Emission Trading Schemes?	5
Considering the business purpose of the rights.....	6
Accounting for rights held for trading.....	6
Accounting for rights held for compliance activities	6
Other accounting issues.....	9
POSSIBLE DEVELOPMENTS FROM IASB/FASB	10
POSSIBLE NEXT STEPS	10
APPENDIX 1 – LIST OF RESPONDENTS.....	11

INTRODUCTION

Objective

- 1 In May 2012, the French standard setter Autorite des Normes Comptables (ANC) issued the paper 'Accounting of GHG Emissions Rights Reflecting Companies' Business Models' that was intended to 'inspire the international debate and, as soon as possible, the development of an international accounting standard by the IASB.
- 2 In December 2012 EFRAG issued a comment paper to discuss recognition and measurement of emission rights and liabilities under an Emission Trading Scheme with the view to stimulate debate in Europe and beyond.

Level of response to the comment paper

- 3 Eleven (11) comment letters were received in time to be included in the comment letter analysis, the origin of which has been summarised below. Appendix 1 provides an overview of the comments received for the purpose of discussing them. Appendix 2 to this paper lists the respondents who commented on EFRAG's comment paper.

Respondents by type		Respondents by country	
Representative body	3	France	2
National Standard Setters	5	Austria	1
Accountancy Body	1	Germany	1
Preparer	2	Italy	1
		Spain	1
		The Netherlands	1
		Canada	1
		UK	1
		International	2
Total	<u>11</u>	Total	<u>11</u>

EXECUTIVE SUMMARY

- 4 The majority of respondents agreed that specific accounting guidance is needed for emission trading schemes, although others pointed out that entities have developed consistent and accepted accounting practices by now.
- 5 Respondents agreed that the accounting guidance should consider the way in which emission rights will be consumed (either through sale or to discharge the entity's obligation). Most respondents agreed that rights held for trading should be carried at fair value through profit and loss.
- 6 Views were split about the accounting guidance for rights held to discharge the entity's obligation. In particular, views were split about the initial measurement of rights allocated for free and about presenting emission rights and the provision separately or as a net balance.
- 7 In general, respondents believed that entities should be allowed to have limited transfers between the two portfolios or limited sales of rights held for compliance with no accounting consequences.

SUMMARY OF RESPONSES

Is there a need for specific accounting guidance on Emission Trading Schemes?

In its comment paper, EFRAG stated that a no perfect analogy can be drawn from the existing accounting guidance for the accounting treatment of emission rights. Therefore specific accounting guidance should be developed for Emission Trading Schemes.

- 8 The OIC commented that the analysis should start with a question about the economic nature of the rights. The OIC believed that the emission rights allow the entity not to incur any penalties therefore they represent an avoided cost of production. The analysis should then focus on what effects the overall event has on the entity and what real costs are incurred.
- 9 Most of the respondents (AFRAC, ICAC, DASB, IETA, DRSC, OIC, BP, ACTEO) agreed that although there are similarities with inventory and intangible assets, no perfect analogy can be drawn from existing IFRSs. BP pointed out that the requirement to surrender the rights is a specific feature that creates a linkage between the rights and the obligation.
- 10 Emission rights are a material amount that is calculated to be in the range of 14% to 85% of profit and loss before tax. These rights are expected to increase in value and quantity with the development of new carbon markets, for example in California, Quebec, Australia and China. Evidence of diverging accounting practices results in reduced comparability of the information disclosed, lack of relevant information and confusion regarding the application of environmental regulation. As a consequence, it would be appropriate to develop specific guidance.
- 11 CPA Canada and BP noted that there are different schemes both in Europe and other jurisdictions throughout the world, which may have different characteristics. They recommended that any accounting guidance should not be specific only to the EU ETS, but should allow entities to deal with all the different schemes.
- 12 The IEAF and GDF disagreed with the need to develop specific guidance on the topic. It was noted that entities have been dealing with ETS since 2005 and have developed robust accounting policies and practices, one example being the IEAF best practice paper.
- 13 The DRSC noted that they had received similar feedback. These best practices have been applied consistently over time, are accepted by users and should not be ignored. The DRSC would not encourage the development of specific accounting guidance solely on the basis of a specific EU ETS but approaching any identified issue from a holistic perspective in the scope of existing IFRSs. This process should also include careful evaluation whether improvements and clarifications can be considered as necessary changes to long-standing standards, such as IAS 2 *Inventories*, to reflect the changes in business environments over the time.
- 14 Respondents also provided comments on the emission rights' similarity to other asset. AFRAC, ICAC and IETA believe that there are strong arguments to analogise emission rights to intangible assets, since they are identifiable (the rights could be sold, are legally reserved since an emitter needs the licence to pollute and in practical terms each emission allowance has a unique reference number), controlled by the owner who could transfer them, have no physical substance and future economic benefits are expected to flow to the entity since such asset would prevent cash outflows by avoiding penalties. The IETA pointed to court cases where emission rights have been ruled to satisfy the characteristics of intangible assets.

- 15 The IEAF support that emission rights are intangible inventories, a hybrid which has some similarities to intangible assets and some to inventories. GDF noted that utility companies manage emission rights as a commodity.

Considering the business purpose of the rights

In its comment paper EFRAG stated that consideration should be given to how an entity expects to use the rights. The information needed by users differs depending on whether the rights are held with a view to trade to benefit from short-term fluctuations in prices; or the rights are held to be used in the production process and be ultimately surrendered to the authorities.

EFRAG noted that an emitter could carry out both activities. It is therefore important that an entity supports the model followed with appropriate evidence and has appropriate procedures in place so that effective segregation is maintained

- 16 Respondents generally agreed with the EFRAG’s position. ACTEO noted that when assessing the most appropriate accounting approach for each model, the best starting point was to consider the business objective of the activity and then to determine what the impact on performance should be. The developed accounting model should require entities to present the asset in a manner consistent with the presentation of its other assets in accordance with its business substance.
- 17 AFRAC noted that while it might be difficult to distinguish between trading and compliance portfolios, the entity’s past behaviour could be used as a basis. AFRAC also believed 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. The IETA also noted that discipline is required to manage a dual accounting model.
- 18 GDF and DRSC warned against the reference to ‘business model’ in the context of compliance activities. In their view, a reflection of accounting policies based on the entity’s application of emission certificates would be more appropriate; a reference to a business model could be the potential source of a wide range of interpretations by different constituents. GDF suggested considering management purpose.

Accounting for rights held for trading

In its comment paper, EFRAG supported that emission rights held for trading should be measured at fair value, with changes recognised in profit and loss. EFRAG does not expect that cost to sell would be significant for emission rights. In relation to derivative contracts on emission rights, EFRAG noted that the ‘own use’ exemption should not be made available for derivatives entered to purchase rights held for trading.

- 19 In general, respondents agreed with measuring rights held for trading at fair value. ICAC disagreed, because it supports presenting rights held for trading as inventory and under Spanish accounting rules inventory should be carried at cost.

Accounting for rights held for compliance activities

In its comment paper, EFRAG suggested that the accounting for rights and obligations arising from the compliance activity should be as follows:

- (a) Free allocations should be initially recognised at fair value at the date they are received by the entity, with the credit being posted to deferred income or Other Comprehensive Income;*
- (b) A liability and a production cost should be recognised as the entity produces emissions;*
- (c) The emission rights held and the liability should be presented separately, and the liability should be de-recognised when the allowances are surrendered to the authority; and*

(d) The 'own use' exemption is granted for derivatives entered for compliance purposes in accordance with IAS 39 requirements.

EFRAG noted that an entity should not be allowed to use the compliance accounting model when it engages in systematic transfers or sales out of the compliance portfolio. However, it did not reach a conclusion on whether any transfer disqualifies an entity from the use of the compliance model or if marginal sales could be accepted. Being disqualified from using the compliance model would result in having to account for derivatives at fair value through profit and loss.

Initial measurement of rights allocated for free (when held for compliance)

- 20 Views were split on the initial measurement of rights allocated for free. AFRAC, ICAC, DASB and IETA agreed to an initial measurement at fair value. AFRAC noted that these rights meet the definition of assets and should therefore be recognised on the statement of financial position. A fair value, based on the market price at the date of acquisition, could be easily determined since there is a highly liquid market for such rights (AFRAC).
- 21 The IEAF indicated that entities should apply IAS 20 which allows either cost or fair value.
- 22 ACTEO noted that in a compliance model the cost should ultimately reflect the cash flows incurred by the entity. If the entity expects to consume more units than those allocated for free, a FIFO method would not correctly allocate the cost to the units of production (because no cost would be recognised until consumption of the free rights). ACTEO agreed with the way the EFRAG's proposals would represent the impact on the performance, but disagreed with the initial measurement at fair value because it grosses up the balance sheet.
- 23 BP, GDF and OIC disagreed with EFRAG's proposal. BP noted that the economics of receiving a certain level of emissions free of charge is that lower actual expense should be reflected in the income statement. This would be the case when the government issuing the allowances and requiring the surrender of the allowances is the same entity. Therefore, the economics of free emissions will be better reflected by initial recognition at nil. BP and the OIC also believe that no acceptable solution can be found for the credit side of the entry (see below).
- 24 The OIC noted that although the act of emitting is the obligating event for purchased rights, this obligating event is already satisfied when emission rights are assigned for free by the authority. The value of the liability to be repaid through surrendering free rights is zero therefore free rights should be measured at nil value.
- 25 The DRSC questioned if EFRAG's proposals were considered as specific requirements in context of the EU ETS or should be applied to non-monetary government grants in general.

Determining the nature of the credit side if free allocations are initially measured at fair value

- 26 As noted above, only some respondents agreed on initial fair value measurement for rights allocated for free. Among them AFRAC, DASB and IEAF supported crediting the entry in deferred income. AFRAC disagreed with the use of OCI, because the entity's net assets and equity are not increased when the rights are granted but only when used in the production process or sold. The DASB added that although deferred income may not meet the liability definition under the Conceptual Framework, it results in matching and the concept also still currently exists for government grants.
- 27 ICAC and IETA supported using OCI, with ICAC indicating that the entity should recycle as it recognises the production costs.

Separate presentation of the asset and liability in a compliance model

- 28 Views were split about whether an entity should present separately its emission rights and its obligation or the net balance.
- 29 AFRAC and ICAC supported a separate presentation. AFRAC noted that the allowances and the obligations, although related, can be managed separately: 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.
- 30 The DASB agreed that offsetting should not be allowed, because the rights can be separately sold. However, if a company has been allocated sufficient emission rights for its operations for free to settle its liability, then the gross presentation would not provide additional information since such transaction would have no impact on cash flows. Therefore, an alternative should be allowed only for emission rights allocated for free to be presented net. The amount that could be presented net would be deferred income, being the credit of emission rights received for free, to the extent not yet released to income.
- 31 The IETA agreed that offsetting should not be allowed, because emission rights do not qualify as financial assets and the net position cannot be settled in cash. Also, providing updated and accurate information over the accounting period on how organizations are progressing towards their emissions cap is important. However, the IETA noted that other schemes may allow a net settlement in cash and accounting guidance should consider this aspect.
- 32 BP agreed with a separate presentation, but (as noted above) with the rights allocated for free carried at nil.
- 33 The IEAF believes that the most important aspect of the guidance is how it impacts the performance, and that the presentation in the statement of financial position is not crucial. Both alternatives should be allowed.
- 34 GDF believes that a net presentation should be required once the entity has ‘flagged’ the rights for future surrender. At that moment, the entity has lost its control on the rights and they do not qualify as assets anymore.
- 35 ACTEO and OIC supported a net presentation and opposed a gross presentation. They noted that a net presentation best depicts the future cash outflow that the entity will incur to settle the obligation, and that in a compliance model the entity has the right and intention to use the assets to discharge its obligation. It was also noted that since emission rights are an avoided cost of production arising from the legislation, they should impact the balance sheet only for accrual reasons (in accordance with an economic accounting approach).

Subsequent measurement of assets and liabilities in a compliance model

- 36 Among those who support a separate presentation, AFRAC and IETA agreed with EFRAG’s proposal to measure rights at cost less impairment and the provision at the projected average cost. The IETA noted that in case of fluctuations, the use of weighted average cost will allow the changes in emission rights values to be less volatile than with the use of FIFO method.
- 37 The IEAF also agreed with the proposal, assuming that the entity opted for a separate presentation. However, they noted that the net realisable value of emission rights would not be the current market price to the extent that finished products (e.g. electricity) in which they will be incorporated are expected to be sold at or above cost.

- 38 ICAC and DASB supported a FIFO method, with ICAC noting that expected shortfall should be measured at deemed cost rather than current market value at the reporting date. DASB noted that this better reflects the economic situation, in that higher prices of emission rights in the future may be charged to the customer resulting in higher prices/ revenue.
- 39 BP agreed that the measurement of the liability and the assets should be linked, with any excess rights required measured at fair value at the balance sheet date. BP also agreed that the emission rights should be recognised at cost. However, it stated that free allowances should be measured at actual cost (nil), and this would affect the liability since the corresponding liability should be measured at zero. Derivatives entered into for own use should apply hedge accounting.
- 40 As noted above, ACTEO supports presenting the net position at the weighted average cost, using a nil value for free allowances, purchase cost of any additional allowances already purchased and the expected costs of any further allowances required, including the effect of forward purchases or other arrangements.
- 41 GDF would classify emission allowances as inventories, therefore IAS 2 should apply. Any accrual should be recognised in case of shortage (excess of emissions over available allowances), and measured at its best estimate (market price or at price of forward contracts if the cost of production has been hedged).

Should transfers be allowed?

- 42 Respondents did not support the idea that any transfer should immediately prevent an entity from using the compliance model. Respondents noted that differences between forecasts and actual consumptions may arise and do not represent a change in the way the rights are used. The IETA pointed out that limited transfer is an acceptable option for dealing with transfers between trading and compliance portfolios, as it gives organizations the flexibility to provide information on emissions rights they might negotiate before surrender.
- 43 AFRAC however noted that emission trading schemes have been in force for some time, therefore entities should by now have reliable knowledge about their emission volumes. A large, recurring gap between initially estimated and actual volumes should 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.
- 44 The DASB added that a transfer from the compliance to the transfer portfolio should be treated as a revaluation and recognised in accordance with IAS 40.61 (that is, in other comprehensive income) until it is realised through a sale to an external party.
- 45 The DRSC noted that they had received feedback that ‘systematic transfers or sales’ would not necessarily be a helpful and appropriate criterion in order to separate portfolios with trading activities from non-trading portfolios of emission rights or even form a reasonable definition for a trading business model.

Other accounting issues

- 46 Some constituents have added further related areas that need to be addressed:
- (a) Accounting for offset projects, credits and contributions to technology or other funds. (CPA); and
 - (b) Accounting for bio fuel quota schemes (that require the blending of a minimum quantity of bio fuels into petroleum products) which share many of the same accounting questions as Emission Trading Schemes. (BP).

POSSIBLE DEVELOPMENTS FROM IASB/FASB

In its comment paper, EFRAG noted that considerable work has already been done, so there seems to be no need for a research project. It also noted that the withdrawal of IFRIC 3 and divergent accounting practices may show that Emission Trading Schemes have specific features that existing standards do not easily accommodate. Developing an interpretation within the limits of existing IFRSs would not necessarily yield in a satisfactory accounting model.

- 47 There were different positions about the best way forward. AFRAC and DASB agreed that additional research does not seem useful and that the IASB should develop a Standard, since the previous Interpretation process had not been effective. The IETA also agreed but noted that appropriate research could also be carried out at the same time as developing a standard. The research undertaken should explore, for example, the uptake of a new standard, and/or track changes in international Emission Trading Schemes procedures in order to integrate any changes into accounting standards. ICAC instead supported an Interpretation.
- 48 As noted above, GDF believes that no accounting pronouncement is necessary.
- 49 For information, work on emission trading schemes is listed on the IASB's agenda as a research project on which preliminary work has commenced.

POSSIBLE NEXT STEPS

- 50 Based on the discussion at the September TEG meeting, the treatment of emission trading schemes does not seem to be perceived as a priority issue.
- 51 Since the IASB intends to resume work on the topic, EFRAG could support the research in the following ways:
- (a) Discuss with users to understand what type of information they need about Emission Trading Schemes, especially in relation to the financial position of the entity.
 - (b) Taking stock of all existing schemes that share similar characteristics with Emission Trading Schemes, such as renewable energy certificates, energy efficiency credits and carbon pricing schemes. EFRAG staff believes that this could be useful also in relation to the application of the exemption for Emission Trading Schemes in the recently issued IFRIC 21 *Levies*.

APPENDIX 1 – LIST OF RESPONDENTS

<i>Name of respondent</i>	<i>Type of respondent</i>
Austrian Financial Reporting and Auditing Committee (AFRAC)	National Standard Setter
Instituto de Contabilidad y Auditoría de Cuentas (ICAC)	National Standard Setter
Dutch Accounting Standards Board (DASB)	National Standard Setter
International Energy Accounting Forum (IEAF)	Representative Body
CPA Canada	Accountancy Body
Climate Disclosure Standards Board (CDSB) and International Emissions Trading Association (IETA)	Representative Body
GDF Suez	Preparer
ACTEO MEDEF	Representative Body
BP plc	Preparer
Deutsches Rechnungslegung Standards Committee (DRSC)	National Standard Setter
Organismo Italiano di Contabilità (OIC)	National Standard Setter