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

6 May 2005

Dear Dr. Schaub,

Re: Adoption of 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 applying IFRIC 3 will not always result in economic reality being reflected and relevant information being provided. That is because the accounting required by IFRIC in IFRIC 3 is constrained by the IFRIC's interpretation of 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. This 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 of the fact that 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 a specified level; emission rights are the only assets eligible for settlement of the liability for emissions made. Because of these mismatches 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 changes in the market price for the allowances appear 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 may not faithfully represent economic reality particularly in cases where the entity does not trade emission rights.

(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 entities 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.

EFRAG conclusion

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

EFRAG also believes that the disadvantages that would arise from endorsing the interpretation outweigh the advantages of guidance on the accounting on the emission right schemes.

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 that the EU Commission should not 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 participate in the due process, if the 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 that the IFRIC should consider an accounting model in which obtaining and using emission rights should be considered 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. We agree with the IFRIC that a liability arises when emissions are made. However the 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 the liability meets the definition of a provision in the scope of IAS 37 because there is in our opinion no uncertainty about either the timing or the amount when the emissions are made. The liability is not uncertain in timing as the compliance period and settlement date is fixed. Nor is the liability uncertain in amount as according to IFRIC 3 the liability is the direct quantitative number of emissions made valued at the existing market price. Regardless whether it meets the definition of a provision or not, this is however not at the root of our problem with IFRIC 3.

   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 IFRIC's interpretation of the interplay between the existing standards (IASs 38, 20 and 37). EFRAG believes that the application of IFRIC 3 may in certain situations result in an artificial mismatch and therefore in information which is not relevant for users.

3. 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 extinguish the liability only by handing in allowances to the authorities; it cannot be settled with other assets, e.g. cash. It seems therefore illogical to us that the liability is measured at an amount that is 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 eliminated at the settlement date. We believe that explaining the mismatch in the management report does not provide sufficient transparency and understanding of the financial statements as in some industries it may have significant impact on the financial results.

4. 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 achieve an accounting result that is closer to economic reality and provide more relevant information to users both the gains and the losses should be required to be recognised in profit and loss. However we are aware that allowing remeasurement of the allowances at fair value with the resulting gain or loss recognised immediately in profit or loss will not solve the mismatch in its entirety.

5. 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 bases 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.

EFRAG questions whether it is in accordance with the standards that entities 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 fact is not spelled out in the interpretation itself, but only in the illustrative examples.

6. If the entities 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 accounting requirements in IFRIC 3 will have a significant impact on reported financial results in certain industries and will not always reflect economic reality. Therefore we have concluded that the accounting proposed by IFRIC 3 may not provide relevant information for users because it does not faithfully represent the economic reality. For that reason we recommend that the European Commission should not endorse IFRIC 3.

7. The IFRIC is reconsidering the interpretation to improve the accounting quality of the financial information resulting from IFRIC 3. EFRAG will co-operate with the IFRIC on this work and has forwarded proposals for consideration to the IFRIC. 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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