

July xx, 2003

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Chairman IFRIC  
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UK

**EFRAG's PRELIMINARY VIEWS FOR  
COMMENTS BY NO LATER THAN JUNE 27, 2003**

Dear Kevin,

Re: IFRIC Draft Interpretation 1 *Emission Rights*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the draft of the IFRIC Interpretation 1 on Emission Rights ("D1"). This letter is submitted in EFRAG's capacity of contributing to IASB's and IFRIC's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRIC on the issue.

While we believe that the proposed Interpretation is consistent with existing IFRS, we are concerned that, when an entity values its emission rights at historical cost (benchmark treatment), the outcome of the required accounting under D1 becomes inappropriate. Our concern is explained in the next paragraph, including two possible approaches which we believe could address such concern.

Paragraph 8 of D1 requires that, as emissions are made, a liability is recognised for the obligation to deliver rights equal to emissions that have been made. The liability is to be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. This will normally be the present market price of the number of allowances required to cover emissions made up to the balance sheet date. When an entity applies the benchmark treatment under IAS 38 *Intangible Assets*, the draft Interpretation requires that emission rights would be carried at historical cost less any accumulated impairment losses. However, where an entity's emissions equal the rights obtained, but the market price has increased by

the end of the financial year, the draft Interpretation implies that the entity needs to recognise a loss. Subsequently, assuming that the obligation is settled shortly after year-end, a gain would be recognised for the same amount at settlement date. We believe that the outcome of such accounting is inappropriate and can be avoided as follows:

- A solution might be for IFRIC to require emission rights traded in an active market to be measured at present market price with changes in value reported in the income statement. Appendix 1 of this letter contains an illustrative example of our proposal. We recognise that such a requirement is beyond an interpretation of the current standards and therefore believe that a Board modification of IAS 38 would be necessary. BC 9 explains that IFRIC did not pursue an approach whereby emission rights traded in an active market would need to be measured at present market price, with changes in value reported in the income statement, in the light of the Board's project on reporting financial performance. We believe however that the new Reporting Performance requirements will not address our concern explained above. In addition, it is currently unclear what the adoption date for the Reporting Performance standard will be (2005,2006 or later ?).
- Alternatively, IFRIC could consider an accounting model in which the obtaining and use of emission rights are considered as linked transactions. As a result, the rights obtained would be amortised on a systematic basis (e.g. on a "unit-of-pollution" basis) and the entity would only recognise an emission liability when it pollutes more than allowed under its rights held. Appendix 2 contains an illustrative example of our proposal.

**The above represent EFRAG's preliminary views on the IFRIC Draft Interpretation 1 *Emission Rights*. Based on comments received, EFRAG will finalise its considerations at its July meeting.**

If you would like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Johan van Helleman  
EFRAG, Chairman

## **Illustrative example of a present market price approach**

The example is set out below to illustrate a proposed accounting model under which emission rights traded in an active market would be measured at present market price with changes in value reported in the income statement. It is based on an example included with the IFRIC's draft Interpretation.

### *Example 1*

#### **Facts**

The entity is a participant in an emissions right scheme. The scheme operates for annual compliance periods that coincide with the entity's reporting periods. On the first day of the period, the entity is allocated, free of charge, emission rights for the year representing the emission of 12.000 ton of CO<sub>2</sub>. The market price of the emission rights on that day is 10 per ton, giving a fair value of 120.000.

Six months later (at its interim reporting date) the entity has emitted 5.500 ton of CO<sub>2</sub>. It expects its emission for the whole year to be 12.000 ton (i.e. equal to the emission rights obtained). The market price for allowances has risen to 12 per ton.

At year-end, the entity measures its emissions for the year at 12.500 ton. On the last day of the year, it buys additional rights to cover the 500 emissions in excess of the rights it already owns. The market price of the rights at the year-end (and which the entity pays for the extra 500 emission rights) is 9 per ton.

The entity settles the emission liability shortly after year-end.

#### **Accounting entries**

*(all amounts are in '000)*

##### **First day of the year**

Intangible assets	120	
Deferred income (government grant)		120

*The entity recognises the allocation of the rights at their market price (12.000 ton at 10 per ton)*

##### **At the end of the six months period**

Intangible assets	24	
Income statement		24

*The entity recognises the increase in the market value of the rights held (12.000 ton whose price has increased from 10 to 12 per ton)*

Deferred income (government grant)	55	
Income statement		55

*The entity recognises as income the portion of the government grant that matches the costs of emissions in the period*

Expense	66	
Emission liability		66

*The entity recognises the liability for emissions to date (5.500 ton measured at 12 per ton)*

### **At the end of the year**

Income statement	36	
Intangible assets		36

*The entity recognises the decrease in market value of the rights held (12.000 ton whose price has decreased from 12 to 9 per ton)*

Deferred income (government grant)	65	
Income statement		65

*The entity recognises as income the portion of the government grant that matches the costs of emissions in the period*

Expense	46.5	
Emission liability		46.5

*The entity recognises the liability for emissions to date (12.500 ton measured at 9 per ton)*

Intangible assets	4.5	
Cash		4.5

*The entity recognises the purchase of the additional rights at 9 per ton*

### **Subsequent settlement**

Emission liability	112.5	
Intangible assets		112.5

*The entity recognises the settlement of the liability*

## **Illustrative example of proposed alternative accounting model**

### *Example 2*

The example is set out below to illustrate a proposed accounting model under which the obtaining and use of emission rights are considered as linked transactions. As a result, emission rights are considered as consumable assets that are amortised on a “unit-of-pollution” basis. It is based on an example included with the IFRIC’s draft Interpretation.

### **Facts**

The facts are the same as in example 1.

### **Accounting entries**

*(all amounts are in '000)*

#### **First day of the year**

Intangible assets	120	
Deferred income (government grant)		120

*The entity recognises the allocation of the rights at their market price (12.000 ton at 10 per ton)*

#### **At the end of the six months period**

Amortisation Expense	55	
Intangible assets		55

*The entity recognises the use of the emission rights held based on the polluted units (55/120 x 120)*

Deferred income (government grant)	55	
Income statement		55

*The entity recognises as income the portion of the government grant that matches the costs of emissions in the period*

**At the end of the year**

Amortisation expense	65	
Intangible assets		65

*The entity recognises the use of the emission rights held based on the polluted units (120/120 x 120) - 55*

Deferred income (government grant)	65	
Income statement		65

*The entity recognises as income the portion of the government grant that matches the costs of emissions in the period*

Intangible assets	4.5	
Cash		4.5

*The entity recognises the purchase of the additional rights at 9 per ton*

Amortisation expense	4.5	
Intangible assets		4.5

*The entity recognises the use of the emission rights held based on the polluted units (0,5/0,5 x 4,5)*