EFRAG

European Financial Reporting Advisory Group

July 25, 2003

Kevin Stevenson
Chairman IFRIC
30 Cannon Street
London EC4M 6XH
UK

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 is the next paragraph, including our preferred alternative approach which we believe would address this 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 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.

When deliberating possible alternatives with regard to the accounting for emission rights, EFRAG concluded that an asset-liability model as proposed by IFRIC might be conceptually pure but is too complex and does not reflect business reality when an entity uses the emission rights it was granted. Therefore, we believe that IFRIC should 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. If an entity sells emission rights for which it is probable that it will need them to settle its liabilities under the emission scheme, it shall not recognise any gain from that sale. The appendix to this letter contains an illustrative example of our proposal.

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 proposed alternative accounting model

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 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_2. 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_2. 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

A. No sale of emission rights occurs during the scheme period

(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)

B. Emission rights are sold during the scheme period

At the moment of sale of emission rights (assumed to be the first day of the 3rd quarter)

Cash	144	
Intangible assets		65
Emission liabilities		79

The entity sells its emission rights held against the market price of 12 per ton i.e. a consideration of 144. With regard to actual emissions, the entity expects to emit 12.000 ton by the end of the scheme. Therefore, no gain is recognised but instead the difference between the selling price and the carrying amount of the emission rights is presented as an emission liability.

At the end of the year

Emission expense	33,5 *	
Emission liabilities		33,5

The entity will have to remeasure its emission liability to reflect the best estimate of the expenditure required to settle the obligation. The market price is 9 per ton and the entity needs emission rights for 12.500 ton (i.e. actual emissions).

* This amount is the net of the recognition of the gain on the sale of the rights (12.000 x (12 - 10)) plus the decrease of the emission liability of the first half of the year (5.500 ton x (10 - 9)) minus the recognition of the emission liability of the second half of the year (7.000 ton x 9).

Intangible assets	112,5	
Cash		112,5

The entity buys the necessary emission rights to settle its 12.500 ton emission liability.

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

Subsequent settlement

Emission liability	112,5	
Intangible assets		112,5

The entity recognises the settlement of the liability