EFRAG
European Financial Reporting Advisory Group

Emissions Trading Schemes

Draft Comment Paper

Comments should be submitted by 30 April 2013 to commentletters@efrag.org

Background

1 Emission Trading Schemes have been implemented in a number of jurisdictions as a key tool for reducing industrial greenhouse gas emissions. Detailed legislation differs across the various jurisdictions. The European Union Emission Trading Scheme works based on a mandatory 'cap and trade' principle. This means that there is a limit on the total amount of certain greenhouse gases that can be emitted by the factories, power plants and other installations in the system. Within this cap, companies receive emission allowances which they can sell to or buy from one another as needed. If an entity consumes above the cap, it must purchase the right to cover its shortfall on the market; if it consumes less, it can trade the surplus.

2 After the end of each year participants must surrender enough allowances to cover all their emissions; failure to do so results in severe penalties while the obligation to deliver emission rights remains until those are delivered. Participants can keep any surplus to cover obligations in future years, or sell them in the market. Participation in the market of emission rights is open also to entities that do not emit greenhouse gases.

3 A brief description of the EU Emission Trading Scheme is provided in Appendix B.

4 Since IFRIC 3[1] *Emission Rights* was rejected in Europe and subsequently withdrawn, IFRS do not provide specific guidance for the accounting of assets and liabilities arising from participation in an Emission Trading Scheme; this has resulted in diverging practices.

Objective of the Draft Comment Paper

5 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 is intended to 'inspire the international debate and, as soon as possible, the development of an international accounting standard by the IASB'. EFRAG welcomes the ANC's efforts in starting a relevant debate, the regulation affecting a significant number of entities and having potential material impacts..

6 Having the ANC's proposals as starting point, the draft comment paper discusses recognition and measurement of emission rights and liabilities under an Emission Trading Scheme and is intended to stimulate debate in Europe and beyond. EFRAG

[1] IFRIC Interpretation 3 *Emission Rights* was issued in December 2004 and was withdrawn by the IASB in July 2005. Agenda Consultation decision to re-commence research on emissions trading schemes has been taken in May 2012.

intends to publish a feedback statement of all comments received on the present draft comment paper, and on that basis, to publish its recommendations to the IASB.

The specific nature of emission rights

Notes to constituents

7 *The ANC paper notes that emission rights are assets which owing to their specific nature and innovative features cannot easily be covered by the literal accounting definitions of the different classes of assets.*

8 *The ANC specifies that emission rights do not belong to any existing asset category, and they are neither financial instruments (e.g. cash, equity instruments or a contractual right to exchange or receive cash or another financial asset) nor intangible assets, although they do not have physical substance.*

9 *The ANC also notes that emission rights differ from intangible assets such as taxi licenses and fishing quotas, the absence of which could either prevent an activity to be carried out or make it illegal. Therefore, emission rights may not be considered as intangible assets.*

10 *The ANC finally concludes that emission rights are not inventories of physical commodities since they are not physically consumed, although they may be purchased as a result of manufacturing activities.*

11 *The paper nevertheless attempts at addressing emission rights on the basis of existing IFRS requirements.*

EFRAG's analysis

Are emission rights financial assets?

12 Some believe that emission rights are similar to financial assets since an emission right is an asset that can be sold in an active market for cash or can used as part of a contractual right to receive cash from another entity.

13 EFRAG is not persuaded that emission rights meet the definition of financial assets, because they do not represent a right to receive cash (or other financial assets) from third parties. Also, they do not arise from a contract but from a participation in a scheme imposed by law.

14 If an entity is a broker-trader that only buys or sells financial instruments, then emission rights are used to obtain a benefit from short-term fluctuations in price, in a way similar to how entities use financial assets held for trading. EFRAG believes that in those circumstances, an accounting approach based on the financial instruments guidance is appropriate.

15 EFRAG notes that in IFRS 9, the business model of an entity is relevant for the measurement of financial assets.

Are emission rights inventory?

16 Some argue that emission rights are similar to commodities, in the sense that entities participating in the schemes use these rights in their production process. However, EFRAG believes that it is not possible to draw a perfect analogy to inventory, because the rights are not physically consumed during the production process and the entity can complete production without obtaining the emission rights first.

17 Emission rights can be held for sale or to settle the obligation arising from the production process of the entity (although they are not subject to 'physical' consumption). In this regard, emission rights could meet the definition of inventories in IAS 2.

Are emission rights intangible assets?

18 EFRAG thinks that emission rights have characteristics in common with intangible assets: they do not have physical substance, and therefore are not physically consumed during the production process.

19 EFRAG notes that the objective of Emission Trading Schemes is to regulate access to a limited resource (in this case clean air). Governments have long used mechanisms such as airport landing rights, licences to operate radio or television stations, and import licences or quotas to achieve this objective. These assets are included in the scope of IAS 38. The economic logic underlying individual fishing quotas and the Emission Trading Schemes is the same, in that first the cap is set, then actual restrictive activity takes place, and finally the compliance exercise by the Regulator is performed.

20 Some argue that there is a difference between assets such as licenses and emission rights, because owning the rights is not a pre-requisite to carry out the entity's activity, while licenses must be held before starting operations.

21 EFRAG thinks that this is a valid observation. However, licenses are not the only type of assets in the scope of IAS 38, and not all intangible assets are a legal prerequisite to operate a business. For instance, a television network must have a license to broadcast before starting to operate; but it is not legally required to produce its own library of programmes, and could instead use third-party programmes under a license agreement.

22 Therefore, EFRAG believes it is not possible to argue conclusively that emission rights are intangible assets.

23 However the accounting implication of classifying emission rights as intangible assets under current IFRS would be that the entity could measure these rights applying either a cost or a revaluation model. If the revaluation model were to be applied, increases in value would be recognised in equity.

24 In the IFRIC 3 model, emission rights were considered intangible assets. Since IFRIC 3 required separate recognition of the rights and the obligation created by emitting, the measurement of rights resulted in accounting mismatch because:

(a) In the cost model, the liability would be measured at current value, and would be different from the carrying amount of the asset;

(b) In the revaluation model, the carrying amount of the asset and liability would match, but the remeasurement of the asset would go the OCI, while the remeasurement of the liability would go to the income statement.

Is there any other feature that makes emission rights different?

25 Participating in an emission trading scheme will lead the entity to eventually return rights (in the EU Emission Trading Schemes, after the end of each annual period) to settle the obligation created over the period. This linkage between the rights and the obligation arising under the Emission Trading Schemes is an additional specific feature that differentiates them from other types of assets.

Need for accounting guidance

26 As a consequence of the above, EFRAG believes that a perfect analogy cannot 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.

27 More consideration is given in paragraphs 103 to 106 below about whether this guidance should take the form of an accounting standard or an interpretation.

Questions to constituents

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

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

Considering the business purpose of the rights

Notes to constituents

30 *The ANC paper assumes that recognition and measurement of emission rights should be based on the use to which the rights are put*.

31 *Greenhouse gas emissions lead to new production expenses. Unlike taxes, greenhouse gas emissions do not lead to direct payments to the State but to an obligation to surrender emission rights to it. As the number of emission rights allocated for free is reduced, GHG emissions lead to an obligation to purchase emission rights. Purchasing is correlated to the production cycle. This is reflected in practice where emission rights are managed in the same way as all essential commodities; they can be purchased to be used in the production process or/and to be sold on.*

32 *Therefore, the accounting that applies depends on whether companies are going to use the purchased emission rights for compliance or trading purposes.*

Model	**Production**	**Trading**
Purchase	Obligatory Related to the production activity	Voluntary Separate from the production activity
Purpose of purchase	Compliance	Appreciation in value / gains
Consequence of purchase	Freezes the production cost Ensures compliance	Does not freeze the production cost Does not guarantee compliance Held with a view to generate a trading gain
Surrendering emission rights to the State	Proves (evidence of) compliance	Not applicable

EFRAG's analysis

33 EFRAG believes that consideration should be given to how an entity expects to use the rights. In the EU scheme, rights can be purchased and traded by entities that are not obliged to take part in the scheme; and rights allocated for free to emitters can be freely traded on the market (in other words, there is no legal constraint on the use of free allowances).

34 EFRAG notes that for the reasons explained below, 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.

35 In these two models, entities are trying to achieve two different objectives. The objective of the trading model is to maximise profit; the objective of the compliance model is first to avoid penalties, but also to maintain their production cost under control and avoid unexpected variability.

36 In the trading model, users need to understand:

(a) Gains and losses arising from the trading activity, information supported by the understanding of the risk management of the entity.

(b) Emission rights held and derivatives at current value.

In the trading model, the entity attempts to profit from fluctuations in value of emission rights, therefore current measurement may best serve users' needs.

37 In the compliance model, users need the following information to project future cash flows:

(a) The cost of pollution that the entity bears due to its activities less the gain that free allowances represent, and this being reflected in each accounting period as the best possible depiction of the real monetary cost to the entity; the net cost of production should not be influenced by either the possible level or timing of buying and selling the rights. Information about the possible impact of capital expenditure on pollution levels and progressive reductions in emission right grants will supplement this income statement information to help users project future cash flows (if the cost of pollution is significant to the overall cost of production of the entity).

(b) How the entity can face its surrendering obligation, when time comes, understanding separately the liability incurred to date and the assets held to meet that obligation.

The changes in value of the emission rights held for compliance are irrelevant to the information described above. Therefore measurement based on purchase cost for rights acquired on the market, and on deemed cost (being the fair value at the date of reception) for free allowances may best serve users' needs.

38 However, it should be noted that an emitter could carry out both activities, and this is common practice for many groups. EFRAG believes that an entity needs to support

the model followed with appropriate evidence, and provide adequate disclosure[2]. In practice an entity would need to have appropriate procedures in place so that effective segregation is maintained. Such segregation should also be supported by well-documented internal processes followed by the entity. This is necessary to safeguard that the financial information produced is reliable, informative to users and transparent. These procedures and internal processes are similar from what entities do with other commodities such as oil or gas.

Questions to constituents

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

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

Accounting for rights held for trading

Notes to constituents

41 *The 'Trading' model recognises rights as inventory since they are managed as asset held for sale under the entity's normal activity. Under IFRS, emission rights should be initially and subsequently measured at fair value less costs to sell, with changes thereof recognised in the profit and loss in the period of change (IAS2.3 and 2.5). This reflects the fact that these assets were purchased voluntarily and are held for trading.*

EFRAG's analysis

42 EFRAG believes that emission rights held for trading should be measured at fair value, with changes recognised in profit and loss. We note that in the ANC paper reference is made to paragraph 5 of IAS 2, which permits brokers-traders to carry their inventories at fair value less cost to sell. However, we understand that the ANC would require the trading portfolio to be carried at fair value less costs to sell.

43 Some argue that the appropriate measurement would be at fair value less cost to sell. However, EFRAG notes that the rights are exchanged in the emission registry where emitters and traders are registered, and exchanges take place by logging in the detail of the transaction. Therefore, the administrative cost is likely negligible. Also, the market is now fully developed (in 2009 89 billion euros of allowances and derivatives changed hands in the EU Emission Trading Schemes, based on the World Bank). Therefore, we would not expect a significant difference between fair value and fair value less cost to sell.

44 On several markets, it is possible to trade derivative contracts on emission rights. Under existing IAS 39, entities must recognise derivatives and carry them at fair value, unless the so-called 'own use' exemption applies. Contracts that are entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements are exempt from the application of IAS 39. Paragraph 6 of IAS 39 specifies when the exemption is not applicable.

[2] In this discussion EFRAG does not address if disclosure of the entity's processes and policies should be presented in the notes to the financial statements or in some other part of financial reporting.

45 EFRAG believes that the conditions to apply the 'own use' exemption should be extended to cover derivatives on emission rights. The 'own use' exemption should not be made available for derivatives entered to purchase rights held for trading, as trading activities should be reported at fair value for the reasons explained above.

Accounting for compliance activities

Notes to constituents

46 *The ANC paper recommends the following accounting treatment for the compliance portfolio:*

(a) *Free allocations are initially and subsequently measured at nil;*

(b) *Purchased rights are carried at cost less impairment, and are expensed as production cost as the entity emits greenhouse gases;*

(c) *A liability is recognised when the entity has emitted more than it is holding rights;*

(d) *The liability is discharged by the purchase of allowances;*

(e) *The liability is valued at the fair value of emission rights, unless the company has fixed the purchase price of emission rights with a forward contract. In such case, the liability is first valued using the purchase price of the contract entered into the compliance period, and then for any residual excess use the market value on the date the liability is recognised; and*

(f) *The entity is granted 'own use' exemptions for derivatives. We understand that the entity applies the IAS 39 requirements to assess when the 'own use' exemption is available.*

Recognition and derecognition of assets and liabilities in a compliance model

47 EFRAG believes 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. The credit side of the entry is discussed below;

(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.

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

48 It should be noted that in the EU Emission Trading Schemes free allocations are being progressively phased out over the third phase which will cover 2013 to 2020. Industries such as electric power generation will not be allocated any free allowances, and will only be able to carry forward allowances left over from phase two. For this reason, some argue that accounting for free allowances is only of passing concern

and should not be the key focus in developing an accounting model for Emission Trading Schemes.

49 However, based on information received from the European Commission, free allocations will continue to cover up to 50% of the participating entities' emissions. Also, it should be noted that the EU Emission Trading Schemes is not the only emission trading scheme in existence, and that accounting guidance should cover all types of schemes.

50 EFRAG believes that if an entity is an emitter, then separate events are taking place, namely receiving free allowances, purchasing, emitting and handling the rights during the period are different events that should be recognised separately (asset/ liability/ income and expense), since collapsing everything into one line would result in relevant information being lost and hence it would be difficult for the user to understand the economic activity that should be captured by the accounting treatment. EFRAG supports the separate presentation of such items as it would result in more appropriate presentation of the company's financial performance and position. Separate presentation is discussed in more detail in paragraphs 71 to 75 below.

51 EFRAG questions whether measurement of rights allocated for free at nil is appropriate. When a jurisdiction introduces a cap and trade scheme, there is a change in the rights and obligations and prospects for future cash flows of entities that participate in it. The stated ultimate objective of these schemes is to incorporate the value of the external cost of pollution in the production process so as to create an incentive to reduce the volume of emissions. Entities have now to pay for the use of a resource that before the introduction of the scheme was free. Not recognising these rights and obligations arising from participating in the scheme seems to omit relevant information.

52 Moreover, if an entity measured allocated allowances at nil, and assessed its shortfall based on its net position at a point in time, no cost would be recognised until the entity had consumed the allocated allowances. Therefore, the production cost until that moment would not reflect the 'cost reimbursed by the State' for the scheme. The entity would start recognising a cost of production for the emission rights only when it has fully consumed the allocated allowances.

53 However, some people believe that this outcome could be avoided in another way. The entity could measure the allocated allowances at nil, but project the shortfall at the end of the year and apportion over time. For instance, if the entity received 50 allowances and expected to consume 80 in total, it could recognise half of the expected shortfall in its half year interim financial statements, regardless of the real consumption. EFRAG acknowledges that this may be an alternative solution, but prefers to measure the liability based on the actual emissions, because we think that the act of emitting is the real obligating event.

54 Finally, recognising free allocations at nil would result in a gain if and when an entity decided to sell them. While an entity would not be expected to trade rights that have been designated for compliance purposes, there are no legal constraints to prevent this. Recognition of such a gain would not be a fair characterisation of the trading activity. Moreover such trading activity would impact the level and the timing of recognition of the production cost, with adverse effect on the relevance, comparability and usefulness of information in the context of a compliance model.

55 It would be possible to require an entity to defer the gain in case of sale of rights originally recognised at nil. However, there is no clear precedent for requiring deferral of gains on the sale of an asset when an entity has effectively transferred control and the related risks and rewards.

Questions to constituents

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

57 If not, what arguments detailed above do you not find convincing? How do you respond to them?

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

58 If an entity initially measures the free allocations at their fair value, a question arises on whether it should recognise a liability as the other side of the entry. The IASB has discussed in the past whether participation in an Emission Trading Schemes creates a liability[3].

59 EFRAG acknowledges that it would be difficult to justify the initial recognition of a liability. The mere participation in the Emission Trading Schemes does not in itself create an obligation to return those allowances to the State, although some schemes have a 'clawback' provision that requires entities to return allowances if they stop the plant operations. The clawback provision creates an additional question for some on whether the entity controls the asset received at inception or acquires control only after the entity has operated over the period. In EFRAG's view, however, entities have control on the decision of staying in operation. Therefore, an entity should recognise a liability for the obligation to return free allowances under a clawback provision only when the decision to close the plant is announced.

60 Some say that participation in a scheme commits an entity to reduce the current level of emissions, and this would represent an obligation to perform. EFRAG disagrees with this view. Participation in a scheme induces an entity to reduce its current level of emissions, and hence does not create any obligation. Moreover, the fair value of the free allocations would not be an appropriate measure of this, would it be an obligation.

61 However, many have argued that the obligation to surrender rights does not occur until the entity has emitted. Entities participating in the scheme are likely to continue operations, but this continuation is in itself a future event, and hence should not drive the recognition of a liability.

62 EFRAG agrees with this view. Until the entity has started emitting, it can take actions that enable it to avoid delivering allowances. The fact that free allocations cover only part of the expected emissions – and therefore, following the introduction of the scheme entities will likely incur cash outflows to purchase additional rights – does not in itself constitute a present obligation.

63 If an entity does not recognise a liability, it has the following alternatives:

(a) Recognise a Day-1 gain;

(b) Recognise deferred income; or

(c) Charge the credit to Other Comprehensive Income and recycle later.

[3] Discussion in the joint IASB/ FASB Joint Board Meeting September 2010 on the *Existence and recognition of liabilities for the allocation in a cap and trade scheme.*

No recognition of Day-1 gain

64 EFRAG does not agree with recognising a Day-1 gain. The objective of the scheme is to create an incentive to reduce emissions – the EU has for instance stipulated an objective to reduce greenhouse gases until 2020 by 21% compared to 2005 levels. Scarcity will give the rights value, so allocations are meant to cover only part of the expected emissions. Therefore, entities will likely incur outflows to meet the obligations arising from the scheme; that is, participation in the scheme does not result in an entity receiving a free gift.

Recognising deferred income?

65 Free allocations could be seen as compensation for expenses that the emitter will have to incur over the compliance period, and therefore it would be appropriate to defer their recognition in profit and loss over that period. One way to achieve this is to post the credit side as deferred income.

66 The free allocations have been often viewed as a government grant of non-monetary assets. IAS 20 defines government grants as '*assistance by government in the form of transfer of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity'.* Paragraph 20 of IAS 20 notes that a grant receivable as compensation for expenses or losses already incurred shall be recognised in profit and loss of the period in which it becomes receivable. The IASB indicated long ago its intention to revise IAS 20 because it led to recognising items as liabilities that did not meet the definition of a liability.

67 The discussion that has arisen with the draft interpretation on Levies (September 2012) has shown that the rightful application of the current definition of a liability may lead, in specific circumstances, to what is seen by many as an inappropriate depiction of performance. The definitions of elements is to be discussed as part of the revision of the Conceptual Framework and until that is done some believe that the current possibility to account for deferred income should not be dismissed.

Recognising other comprehensive income and recycling later?

68 Another alternative would be to recognise a credit to Other Comprehensive Income. Some think that free allowances being no free gift to the entity, the entity should not reflect any increase in equity, let it be through comprehensive income. Those who support recognition of the grant in OCI at inception think that with the set up of an Emission Trading Schemes new economic circumstances have arisen whereby it is no longer possible to pollute without paying. The free allocations are indeed a grant and an economic resource, the economic resource the entity receives to help transitioning to these new economic conditions. They understand that the use of OCI will be thoroughly discussed as part of the revision of the conceptual framework. They think however that the use of OCI is helpful to solve tensions that may arise between the choice of a measurement attribute that is the most relevant for balance sheet presentation; however that does not necessarily lead to relevant profit or loss.

69 Whatever option is chosen – deferred income or OCI – the guidance should specify the pattern of recognition of this amount in profit and loss. We address this issue below.

Question to constituents

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

Separate presentation of the asset and liability in a compliance model

71 As mentioned above EFRAG does not support the net liability presentation where the emission rights asset held is used to settle the obligation. The economic linkage should not result in derecognition of the asset and the liability, because the entity will surrender control of the rights and be relieved of the liability only when the emission rights will be transferred and only when the rights are surrendered to the authority, respectively.

72 The entity's ability and intention to use its assets to settle its obligations does not normally lead to derecognition of assets. Examples of such situations are:

(a) An entity may intend to use its spare parts to carry out warranty interventions. IAS 37 does not require or permit the inventory and the warranty provisions to be offset;

(b) An entity may intend to use its inventory to settle an obligation to redeem award credits. IFRIC 13 *Customer Loyalty Programmes* requires to recognise a separate deferred credit for the obligation until redemption;

(c) An entity may intend to settle a dividend by distributing a non-cash item. IFRIC 17 *Distributions of Non-cash Assets to Owners* requires derecognition of the liability and the asset distributed only when the entity settles the dividend payable.

73 Moreover, EFRAG believes that surrendering rights is more than a compliance exercise and does require balance sheet representation. Emission rights have economic value and holding them or not, trading them and being liable to surrendering what is being held affects the entity's financial position. Appropriate presentation and measurement of such information is relevant to users in helping them evaluate the economic events that have taken place and base their predictions for future cash flows.

74 Some have pointed that IAS 32 requires an entity to offset a financial asset and a financial liability when there is a legally enforceable right and the entity intends to settle on a net basis. Based on this premise, an entity should offset emission rights and liabilities in a compliance model because those conditions are met.

75 However, EFRAG is not persuaded that the criteria in IAS 32 could be applied by analogy to Emission Trading Schemes. Offsetting in IAS 32 results in the recognition of a net asset or liability that the entity has the right to either receive or settle with the counterparty in the market. An entity's net position in an Emission Trading Scheme does not represent an amount that can be settled in cash. An entity that is in a surplus position still carries an obligation to return rights to the Regulator; an entity that is in a shortfall cannot simply pay the cash equivalent, but has to purchase the additional rights on the markets and then surrender all the rights (those already in its possession plus the additional rights purchased).

Questions to constituents

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

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)?

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 presentation is relevant to users?

Subsequent measurement of assets and liabilities in a compliance model

79 In subsequent periods, EFRAG would consider the following treatment appropriate:

(a) All rights (free allocations and purchased rights) should be carried at cost less impairment (the deemed cost of free allocations being their initial fair value);

(b) The release of the deferred income (or OCI) should be recognised as a negative production cost;

(c) The liability should be measured based on the expected weighted average cost for the year; and

(d) When surrendering the rights, an entity should derecognise the liability and the rights surrendered.

80 The expected weighted average cost for the year should consider all costs incurred to acquire the emission rights and use this cost to measure the liability. The weighted average cost should be determined as:

(a) the average of the carrying amount of the rights held for compliance (free and purchased); and

(b) for the expected shortfall, as the difference between the expected total consumption and the number of rights currently held for compliance purposes:

(i) the purchase price of forward contracts entered into for compliance period;

(ii) for any residual excess, the current market value at the reporting date.

Linking the measurement of the liability to the carrying amount of the rights held would reduce the accounting mismatches which were created under the IFRIC 3 model.

81 Based on the above, if an entity has already purchased or entered into forward purchase contract for the expected consumption, the production cost will be set at the level decided by the entity.

82 EFRAG believes that using the expected weighted average cost for the calculation of the emission rights liability and production cost, will result in appropriate representation of both the liability and the production cost components. The choice of a specific identification method, for example a first-in-first-out or a last-in-first-out approach, would not seem appropriate for use in the measurement of emission rights

because rights are fungible and are consumed only when they are returned. A weighted average method is practical and ensures consistency in the product cost used since the same cost will be applied to all production (unless there is new purchase that changes the weighted average).

83 Some people object that a liability should not be measured at the carrying amount of the resources required to fulfil it. However, linking the measurement of the liability to the measurement of the asset is an approach that currently exists in IFRS 3 (see below) and is being explored by the IASB in the context of participating insurance contracts. Under this approach, in order to avoid accounting mismatches, the insurer measures and presents the part of the obligation that relates to the underlying items on the same basis as it measures and presents those underlying items. For example, if an insurance contract gives rights to 90% of the revaluation surplus of an investment property, the measurement of the insurance liability would disregard such surplus if the investment property is measured at cost in the financial statements. In addition, under the mirroring approach, an insurer should present changes in the insurance liability in the statement of comprehensive income consistently with the presentation of changes in the linked items (that is, in the profit and loss, or in other comprehensive income).

84 IFRS 3 paragraphs 27-28 also uses an approach of linked measurement in the case of indemnification assets, where the seller of the business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to a specific asset or liability. For example, if the seller indemnifies the acquirer against losses above a specified amount on a liability arising from a contingency. This would result in an indemnification asset, which should be recognised at the same time and basis as the indemnified item.

85 The deferred income should be released (or the OCI should be recycled) based on the ratio between actual and expected emissions. This will ensure that the profit and loss shows a production cost that reflects the real cost of the scheme for the entity.

86 EFRAG notes that usually recycling of OCI occurs when the related asset is sold or derecognised – such is the case with the remeasurement of available-for-sale assets under IAS 39, or the cumulative translation adjustment arising on an entity's investment in a foreign operation. However, we note that within a compliance model the entity is not expected to be selling those rights, but hold them until they are surrendered to the authorities.

87 An illustrative example is provided in the Appendix A.

Question to constituents

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

Segregation of models

89 EFRAG believes that the identification of the business model is especially important in assessing whether an entity should be allowed to use the 'own use exemption' for the measurement of its forward contracts entered for compliance purposes.

90 EFRAG agrees that the existing relevant guidance for own use contracts is appropriate for the treatment of these contracts. Entities holding rights for compliance purposes only should apply the "own use" for these forward contracts if the contracts were entered into, and continue to be held, for the receipt/ delivery of allowances to

meet the company's own compliance requirements. The "own use" exception results in these forward contracts being accounted for as executory contracts rather than derivatives.

Should transfers be allowed?

91 If, as suggested above, accounting was differentiated based on the entity's business model, the accounting implications of transfers between portfolios should be addressed. In particular, the issue is if an emitter should be allowed to transfer rights held for compliance to the trading portfolio. In the context of this analysis, it is considered that the accounting implications of both transfers and sales out of the compliance portfolio should be analysed jointly.

92 EFRAG believes that an entity that engages in systematic transfers or sales out of the compliance portfolio should not be allowed to apply the compliance accounting model described above. However, EFRAG does not believe that the accounting implication in these circumstances should be that an emitter is forced to carry the rights held for compliance purposes at fair value, essentially treating the rights as held for trading. Participation in the Emission Trading Schemes is compulsory; therefore emitters will be obliged to return some of their rights. Forcing emitters to record potential gains on rights that will be surrendered may not provide useful information.

93 In EFRAG's view, the accounting implication of a level of transfers incompatible with an objective of compliance should result in the loss of the use of the 'own use' exemption.

94 There are two possible criteria to identify a level of transfers incompatible with an objective of compliance that would therefore trigger the accounting implications described in the previous paragraphs.

95 A first criterion would be to accept only occasional transfers of marginal quantities of rights to the trading portfolio. Therefore, only when the entity exceeds these limits, it would lose the use of 'own use' exemption.

96 The basis for accepting occasional transfers of marginal quantities is that entities purchase rights for compliance purposes based on expected future consumption, and actual consumption will inevitably differ from forecast. When an entity ends up with excess rights because of an unexpected lower consumption, selling the excess is not a change in the business model but it is simply a correction of the previous transactions.

97 Under an alternative criterion, any transfer, regardless of the size or frequency, would be deemed incompatible with the use of the compliance accounting model. IFRS 9 provides an example of measurement attributes based (not exclusively) on the entity's business model and in IFRS 9 reclassifications are not allowed, but only required when an entity changes its business model.

98 EFRAG acknowledges that there is no perfect analogy between emitters and banks because emission rights held for trading and compliance are likely managed by the same function. However, the arguments used by the IASB to prohibit voluntary reclassifications under IFRS 9 seem applicable to any accounting treatment based on the entity's business model.

99 Moreover, in the EU Emission Trading Schemes so far entities have been allowed to carry forward their excess rights to subsequent years, also between different phases. Therefore, entities are not forced to trade the rights in excess as the only way to avoid losing them.

100 Finally, it should be noted that allowing limited transfers requires the application of judgement that may result in divergence in practice. Should the limits be based on frequency of the transfers, or their size, or both? Should they be allowed only close to the end of the annual periods, or during the full term?

101 Under both alternative criteria, an accounting model that would allow systematic transfers or sales out of the compliance portfolio would invalidate the compliance model.

Question to constituents

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

Options for the IASB going forward

103 If the IASB resumes its project on Emission Trading Schemes, it could use alternative approaches:

(a) Start a research project;

(b) Develop a standard; or

(c) Have the IFRS Interpretations Committee work on an interpretation.

104 EFRAG notes that considerable work has been done on accounting for Emission Trading Schemes, by the IASB, national standard setters and industry associations. In 2012, besides the ANC paper, the Italian standard setter has published a draft standard for entities reporting under Italian GAAP; in prior years the Spanish ICAC and the Belgian Commission des Normes Comptables also issued recommendations on the topic, whereas Eurelectric is finalising a paper on carbon accounting. Other standard setters have also debated or issued guidance on the subject in the past.

105 EFRAG notes that the EU Emission Trading Schemes has expanded in scope (both in terms of industries affected, and types of emissions) and other similar schemes are being developed around the world. Also, more stringent objectives are likely to drive prices of emission rights up and increase the materiality of the impact on entities' reporting. For this reason, we think that the IASB should move ahead rapidly in developing guidance.

106 EFRAG also thinks 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. Moreover, the interpretation would likely be based on standards such as IAS 20 and IAS 37, which the Board has considered amending. In that case, the Board would then have to review the guidance on Emission Trading Schemes.

Question to constituents

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

Other accounting issues

108 If the IASB were to resume its project on Emission Trading Schemes, EFRAG believes that this project should cover the following:

(a) accounting treatment of credit and baseline schemes. These schemes (an example being renewable energy certificates) are similar to cap and trade schemes, but have features that may require specific guidance. In a credit and baseline scheme, credits are issued to sources whose emissions remain below their associated baseline. Hence, in these schemes the entity has to perform the activity (such as, operating wind farms and other renewable sources) before receiving the credits. Moreover, these certificates are – as part of the EU Emission Trading Schemes scheme - available to entities to fulfil their surrendering obligations. Therefore appropriate accounting guidance is necessary to comprehensively address the accounting for European Emission Trading Schemes;

(b) recognition of future instalments of free allocations. Emission Trading Schemes often require entities to surrender rights on an annual basis[4]. Participating entities normally are required to stay in operation to obtain future instalments. Therefore, there is an issue of whether an entity should recognise only the rights that have been issued, or all the allocations expected over the multi-year term:

    (i) Recognising all the free allocations for the multi-year period upfront would reflect the economic situation, that the entity would have the ability to trade an asset, recognise gains and temporarily increase cash flows.

    (ii) On the other hand, such receipt of future allocation might have certain limitations imposed by the regulator, such as a limitation to use a specific year allocation to settle the obligation for a prior or following year. Also, it may be argued that the right to receive future allocations arises only at the start of the following compliance period; and that the number of future allocations may not be reliably measured;

(c) a closely related issue is the accounting implication of ‘banking’ (i.e. the ability to carry forward ‘unused’ allowances into a subsequent period) and ‘borrowing’ (i.e. the ability to use allowances from a subsequent period to settle the obligation for a prior period) rules;

(d) recognition of any incentives and subsidies that entities receive from governments, such as additional free allocations for specific industries;

(e) implications for accounting for business combination, when an emitter is the acquiree;

(f) disclosure requirements.

[4] The EU Emission Trading Scheme is run in distinct phases. Each phase runs for several calendar years. The compliance period is set by the Regulator and could range from twelve months or more. After the end of the compliance period, the entity needs to surrender its allowances to the Regulator.

APPENDIX A

Illustrative example of EFRAG's proposed accounting treatment

Entity A is an emitter and does not hold rights with a view to sell.

At 30 June, assume the following:

	Units	FV per unit	Monetary cost per unit	Total FV	Total cost
Free rights	50	3(*)	–	150	0
Expected purchases	50	4(**)	4	200	200
Expected consumption	100			350	200
			Average value	3.5	2.0

(*) at the date when the free rights are received by the entity

(**) based on current market price at 30 June, since the entity has not entered in forward purchase contracts.

At 30 June, the entity has consumed 40 units.

Date	Debit	Credit	CU
	To recognise initial allocation		
1/1	Emission rights	Deferred income (OCI)	150
	To recognise liability		
30/6	Production cost	Liability	140 (1)
	Deferred income (OCI)	Production cost	60 (2)

(1) 40 units (actual emissions) * 3.5 (expected weighted average)

(2) 40/100 (actual on total expected emissions) * 150

The net production cost of 80 reflects the actual emissions of 40 units and the expected weighted average monetary cost of 2.0.

At 31 December, the data are the following

	Units	FV per unit	Monetary cost per unit	Total FV	Total cost
Free rights	50	3	0	150	0
Purchases	60	4.5	4.5	270	270
Actual consumption	110			420	270
			Average value	3.81	2.45

The entity has consumed 110 units.

Date	Debit	Credit	CU
	To recognise the liability		
31/12	Production cost	Liability	280
	Deferred income (OCI)	Production cost	90
	To recognise the surrender of rights		
30/4	Liability	Emission rights	420

The amount of the liability reflects the carrying amounts of the assets held to settle it.

The net production cost of 270 reflects the actual emissions of 110 and the weighted average cost of 2.45

APPENDIX B

Brief description of the EU Emissions Trading System (EU Emission Trading Schemes*)*

1 The EU Emission Trading Schemes will help the European Union to achieve its emission reduction target under the Kyoto Protocol.

2 Operated since 2005, EU Emission Trading Schemes is a mandatory cap-and-trade system, covering major emitters (about 12,000 installations) in multiple sectors in 30 countries representing 50% of the EU's CO2 emissions.

3 It regulates direct emissions at the point of emission by putting a price on each tonne of carbon emitted and therefore rewarding investment in low-carbon technologies and innovation. A cap is set on total CO2 emissions from all plants covered. Emission allowances form the common trading currency with one allowance giving the right to emit one tonne of CO2[5]. The cap and allocation of allowances are set ahead of each trading period, with no subsequent adjustment. From 2013 some adjustments to the free allocation will be allowed for significant extensions or reductions of capacity. The law allows allowances to be traded on the market.

4 From its start in 2005 the Scheme covers, CO2 emissions from high-emitting plants and factories that are situated in 27 Member States. From 2008, N_2O emissions from nitric acid production and plants in Iceland, Lichtenstein and Norway are also included.

5 From 2012, CO2 emissions from aviation will also be included. Airlines will need allowances to cover the emissions from their flights to, from or within the EU.

6 From 2013 additional gasses and installations undertaking the capture, transport and geological storage of greenhouse gases, and additional high-emitting plants will also come under the Scheme.

7 The EU Emission Trading Schemes is open to establishing formal links with other compatible mandatory cap-and-trade systems for greenhouse gases operating around the world.

8 After the end of each year, (on the 30 April of the following year) installations must surrender a number of allowances equal to their verified CO2 emissions. Installations must comply with monitoring and reporting requirements. Installations that do not surrender enough allowances to cover their emissions must pay a penalty of €100 per tonne and acquire and surrender the missing allowances.

9 A limited number of international credits can be used instead of allowances to provide an incentive for climate action in developing countries. At present, nuclear, land use and forestry credits are not allowed. In addition, conditions are attached to the use in the EU Emission Trading Scheme of carbon credits from large hydro projects.

10 The European carbon price is determined by the interplay of supply and demand, sending the right price signal for investment in cleaner technology. Periodic reviews by the regulator are foreseen to incorporate experience and new developments, no ad-hoc regulatory intervention is allowed.

[5] It also covers other greenhouse gas emissions, so one emission allowances gives a right to emit greenhouse gases with a global warming potential equivalent to 1 tonne of CO2.

11 The EU Emission Trading Scheme is implemented gradually in phases (trading periods):

(a) Phase 1: (January 2005 to December 2007) Establishment of a price for carbon, trading infrastructure and monitoring for emission allowances across the EU and of a base for future robust caps.

(b) Phase 2: (January 2008 to December 2012) Average cap was tightened to 6.5% below the 2005 level.

(c) Phase 3: (January 2013 to December 2020) The scope of the scheme extended to capture additional sectors and gases. Revised legislation will substantially improve the system, including a single EU-wide cap instead of national caps, reducing by 1.74% each year. This predictable cap allows business to plan investment decisions into the future. Emissions for the sectors covered expected to be 21% below 2005 levels by 2020.

12 From January 2020 onwards the cap continues to decline at 1.74% per annum, subject to review since the system was set up for an unlimited duration.

13 Auctioning will become the basic principle for allocating allowances from 2013. The power generation sector will in principle have to buy all of its allowances from 2013. For other sectors the transition will be from 20% of allowances auctioned in 2013 to 70% in 2020, aiming for full auctioning by 2027. An exception is made for sectors assessed as being at risk of carbon leakage. It is estimated that more than 50% of allowances will be auctioned from 2013. This is expected to lead to around 1 billion allowances to be auctioned per year by 2020, raising significant revenue for the Member States depending on the carbon price.

14 The EU aims for the creation of an OECD-wide carbon market by 2015, through linking of domestic cap and trade systems and gradual inclusion of emerging economies and competitive sectors.

Source European Commission, and http://ec.europa.eu/clima/policies/ets/index_en.htm