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Kevin Stevenson
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International Financial Reporting Interpretations Committee
30 Cannon Street

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Berlin, 15. Juli 2003

Dear Kevin

IFRIC Draft Interpretation D1 Emission rights

This letter is in response to the request for comment on the International Financial Reporting Interpretations Committee (IFRIC) Exposure Draft D 1 *Emission Rights*. We appreciate the opportunity to comment on this proposal.

We agree with the recognition rules proposed by the IFRIC, i.e. that an emission rights scheme gives rise to an asset, a government grant – if the allowances are allocated for less than fair value – and a liability as emissions are made. We also support the proposal regarding fair value measurement of allowances at the date of initial recognition. D1, however, also contains proposals on which we have suggestions to improve the Interpretation or do not agree. In this context our comments are as follows:

Fair value at the inception of a scheme (Par. 6)
At the inception of a scheme it is questionable whether there is already an active market and hence the existence of a fair value for emission rights. We therefore suggest using the penalty set by the scheme as an appropriate surrogate for fair value as long as no active market exists.

Measurement of Provision (Par. 8)
In our view, a problem exists concerning the measurement rules i.e. the application of different measurement principles for the asset and the liability. The asset is initially measured at fair value. In subsequent periods, the carrying amount of the asset is either not adjusted for increases in fair value (benchmark treatment) or it is adjusted, but the changes in fair value are recognised in equity without recycling (allowed

alternative treatment). The liability on the other hand is measured at fair value at each balance sheet date with fair value changes recognised in net profit or loss. Accordingly a mismatch of income and expenses arises that contradicts the economic substance of the transaction.

We therefore regard the measurement for provisions proposed by the IFRIC as inappropriate for the accounting for emission rights. IAS 37.36 and IAS 37.37 require an entity to recognise as a provision "the best estimate of the expenditures required to settle the present obligation at the balance sheet date", being "the amount that an entity would rationally pay to settle the obligation".

Paragraph 8 assumes this being the present market price of the allowances.

We are of the opinion, that the best estimate of the expenditure rather depends upon the question whether an entity holds emission rights to settle the obligation.
We therefore consider the following accounting treatment appropriate assuming that the benchmark treatment in IAS 38 is applied.

- The liability is measured at the value of the rights held, i.e. at the cost or the fair value of rights at the beginning of the period, but is not adjusted for fair value changes during the period. This measurement reflects the fact that an entity usually uses the existing rights to settle its obligations (cf. BC5). As long as the entity holds enough emission rights, there is no reason to buy allowances at current market prices. Therefore, the best estimate of the expenditure required to settle the obligation is the carrying amount of the emission rights.
- To the extent the emissions exceed the number of allowances held by the entity, the additional liability has to be measured at fair value being the current market price (unless the entity hedges this risk by buying a financial instrument. In this case IAS 39 applies.). This is due to the fact that the entity has to buy additional allowances and pay the current market price (or pay a penalty). Thus it is guaranteed that the full obligation is recognised.
- The same treatment applies when the entity decides to sell all or part of its allowances. If the sale of allowances implies that the entity does not hold enough rights to settle its obligations, the liability has to be measured at fair value.

This accounting treatment proposes a measurement that looks through the mere existence of the asset on the one hand and the liability on the other hand and reflects the economic substance of the transaction. Thus, onerous fluctuations in net income that have no effect over time but will distort interim results during a scheme year will be avoided.

This proposal, does not contradict the application of the alternative treatment set out in the illustrative example.

However, we think that the committee should replace the current example and rather give one that reflects the accounting under the benchmark treatment taking our proposal into consideration.

Brokers and other position-taking institutions
We ask IFRIC to consider clarification of the accounting treatment for Brokers and other position-taking institutions.

If you would like any clarification of these comments please contact me.

Yours sincerely,

Professor Dr. Klaus Pohle
President