



Association pour la participation des
entreprises françaises à l'harmonisation
comptable internationale



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EFRAG Draft Comment Paper: Emissions Trading Schemes

Dear Françoise,

We are pleased to respond to EFRAG's invitation to comment on the above draft comment paper (the DCL). We note that development of the DCL was inspired by the publication of the ANC's paper "Accounting of GHG Emission Rights reflecting companies' business models". We expect that resolution of the accounting issues linked to these will become increasingly pressing as jurisdictions create more and more innovative schemes in this area. We therefore welcome the initiative taken by the ANC and EFRAG to address the issue in a timely manner.

1. Need for broad principles that can be widely applied

We are aware of a number of different schemes which exist both in Europe and other jurisdictions throughout the world. Some of these are based on the notion of what may be termed as quotas, but there are other schemes which award valuable credits or certificates as a reward for companies' adopting specific behaviours. As mentioned above, we expect that more innovative schemes will be created continually, and we think it is therefore essential that broad principles be established which can be applied to the many different forms of scheme which are aimed at encouraging or discouraging behaviour with respect to emissions. It would be regrettable to arrive at an accounting approach which can deal only with a small set of emissions-related schemes and then have to start the search for an accounting model all over again.

The comments in this letter are based upon our knowledge of the European schemes, which are the only schemes we have considered at this stage.

2. Accounting categorisation of the Emissions Right/Certificate

- In common with EFRAG and the ANC, we think that emissions rights/certificates (referred to as allowances hereafter) are assets which, owing to certain specific features, cannot be easily placed in a specific category of asset under existing standards. As discussed below, we think that this debate about the nature of the asset is secondary to the wider, more important issue of finding a suitable and useful accounting model. For this reason, we have not dwelt on that issue, but have been able to arrive at the following conclusions: Emissions allowances do satisfy the definition of an asset;
- They are not financial assets (as they do not represent a right to receive cash or other financial assets from a third party and do not result from a contract with a third party according to the definitions of IAS 32/39);
- The “consumption” of the allowances is a cost of production or operations; and
- Allowances do not fully satisfy either the definition of inventory or that of intangible assets, and a specific accounting model should be developed for them.

On balance, we think that a dedicated standard would provide a more robust and durable approach to accounting for emissions rights and related items than an Interpretation, which is of necessity aimed at dealing with a more limited set of circumstances. Such a standard should not be industry-orientated but should deal with the nature of the elements in these schemes and the manner in which they are used.

3. Elements of an appropriate model

In view of the wide variety of schemes that one may expect to be introduced and the consequent necessity of arriving at a model which is appropriate for all such schemes and their participants, we think that the most useful model is one which takes into account the business models of the entities affected. We therefore agree with the ANC and EFRAG that the expected use to which allowances will be put is an important consideration in determining the relevant accounting model. We also agree that there are two different basic models: a trading activity model and a “compliance model”.

In view of the inconclusive assessment of the accounting nature of the allowances, we do not think that the accounting model should (or could) make a definitive statement on the nature of these assets, but should require entities to present the asset in a manner consistent with the presentation of its other assets in accordance with its business substance. For example, for industrial companies or utilities, the most appropriate presentation might be as inventory. On the other hand, presentation as inventory may not be the most relevant presentation for other industries, such as service industries. For the latter, a presentation as an intangible asset might be the most appropriate. The entity must decide upon this using judgement based upon all the relevant factors.

We think that, when assessing the most appropriate accounting approach for each model, the best starting-point is to consider the business objective of the activity and then to determine what the impact on P/L should be.

Trading Activity Model

For the trading model, the essence of the activity is to maximise profit through continual buying and selling. This objective is the same as that of commodity or financial instrument trading, and, in our view, the best representation of this is to take to P/L the difference between the cost of acquisition and the sales value of the allowances. The most appropriate approach is thus to account for the allowances as follows: acquisition at cost and subsequent measurement at fair value, with all gains/losses taken to P/L. We think that current standards could be applied appropriately to this model.

Compliance Model

Cost

We think that it is important to recognise that, for the compliance model, the cost of emission borne by the entity is ultimately the cash outflow that the entity will have to suffer. For any one compliance-period covered by the scheme this payment will be made using a combination of free allowances – if any - and allowances acquired at different prices. Where there will be a need to acquire additional allowances to cover the emissions, we think that an approach in which no cost is recognised until the free allowances are fully “consumed” would be confusing if not actually misleading. We note that this is the approach which would be applied if the Draft Interpretation “Levies” were to be used as a model for emissions quotas. On the contrary, we suggest that the most relevant and useful information is provided when the cost for the period is allocated on a systematic and rational basis to each unit of emission produced. This approach is equally relevant when the reporting period is shorter than the compliance period, and when more allowances are held than are expected to be required to settle the liability for the compliance period.

Thus, we agree with the EFRAG paper that recognition of the expense should occur from the moment the entity produces emissions, irrespective of whether the entity holds allowances or not. This reflects our understanding of the way the schemes function: generally the emissions quotas relate to a period of one year or longer, and are intended to encourage long-term reductions in emissions rather than to be a penalty for exceeding a particular threshold.

The question then arises of how those costs per unit of emission should be valued. In our view, the use of a “First-in, First-out” or similar approach should be avoided, as this would tie the cost of a unit of emission to the timing and manner in which the corresponding allowance was acquired, and in particular, result in the threshold approach that we think is misrepresentative of the economic circumstances of the production or operational cycle. Instead, we think that a weighted average cost method based on the costs of allowances over the whole period of the scheme would provide the most useful information and would be a practical approach. The weighted average cost would take into account the free allowances attributed for the compliance period, the cost of any additional allowances already purchased and the expected costs of any further allowances required, including the effect of any forward purchases or other arrangements which may determine the price of allowances.

The two methods proposed in the DCL (the use of deferred income or OCI with a consequent release to P/L) would achieve a net production cost at a weighted average cost in the P/L in line with the above. However, we disagree with the method proposed by the DCL to achieve this, as the EFRAG approach requires the use of the fair value of the allowances on the date of grant as the deemed initial cost of the allowances granted free of charge, with a corresponding gross-up of the liability.

Balance sheet recognition and measurement

In the compliance model the most important aspect is, in our view, the representation of the actual cost of emissions. The balance sheet approach is derived from this.

In our view, the DCL approach is essentially driven by the use of fair values for the free allowances in the balance sheet, and we do not think that this provides the best representation of the entity's overall position with respect to the liability for emissions produced. We think that the most important information for users is the amount of cash that the entity still has to disburse to settle the liability for emissions already incurred at the balance sheet date. The use of fair value does not give this. On the asset side, it must be remembered that, in the compliance model, the free allowances will be used only to settle the emissions liability, and are recognised at a net nil value in the P/L account under both the DCL proposal and our preferred approach. We are thus not convinced that the use of a fair value for free allowances in the balance sheet provides any informational value about cash flows.

We think that the liability should be measured at the cost of the allowances required to settle it, and thus the real cost to the entity of the allowances to be used to settle the liability should be used to value the liability. We therefore agree with the DCL's proposal to value the liability on the basis of the cost of the allowances to be used to settle it (provided that the appropriate costs are used). This is consistent with our interpretation of the principle of measurement in IAS 37:

The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.¹

The use of the weighted average cost of the allowances held (with free allowances valued at nil) and the expected cost of the additional allowances to be acquired will be the most practical approach and will best represent the cash cost and its allocation over the relevant period.

Balance sheet Presentation

Finally, we think that the most relevant presentation of the emissions allowances and liabilities in the balance sheet will usually be provided by a net presentation: a net asset until allowances are fully consumed or a net liability when there is a deficit. This is the most relevant approach, in our view, for the following reasons:

- Presentation of the gross liability could be misleading – giving the message that the cash outlay required will be greater than it actually is.

¹ Extracted from IAS 37, Provisions, Contingent Liabilities and Contingent Assets. © IFRS Foundation.

- Ultimately the only value of an emission right is to be used to settle the emission liability, and such liabilities can be settled only by an allowance. This unique relationship between the allowance and the liability is such that net presentation represents this best.
- The net presentation best reflects the amounts of future cash flows related to the emissions liability. The net short position (liability) or net long position (asset) is the most relevant way to present this.
- The entity has a legally enforceable right to set off the allowance against the liability, and under the compliance model intends to do this.

This net presentation reflects the cash flow effects of the emissions position in the optimal way: in the case of a net liability - the cash to be paid out to cover emissions already produced, or, in the case of net allowances, the cash already expended on allowances but not yet spoken for by actual emissions.

We trust that the above is helpful to you, and will be pleased to respond to any questions you may have.

Yours sincerely,

ACTEO



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Cc: ANC