Climate Disclosure Standards Board and International Emissions Trading Association

Response to Emission Trading Schemes Draft Comment Paper

About the Climate Disclosure Standards Board (CDSB)

CDSB is an international organization committed to the integration of climate change-related information into mainstream corporate reporting. CDSB advances its mission by acting as a forum for collaboration on how existing standards and practices can be supported and enhanced so as to link financial and climate change-related reporting and respond to regulatory developments. CDSB develops its Climate Change Reporting Framework and guidance based on existing standards, research, analysis and good practice working in close partnership with leading professionals in accountancy, business, standard setting and regulation.

CDSB is a consortium of CERES, CDP, The Climate Group, The Climate Registry, The International Emissions Trading Association (IETA), World Council for Business and Sustainable Development (WCBSD), World Economic Forum (WEF), and the World Resources Institute (WRI).

To find out more about CDSB, visit **www.cdsb.net**.

About the International Emissions Trading Association (IETA)

IETA is a nonprofit business organization created in June 1999 to establish a functional international framework for trading in greenhouse gas emission reductions.

Our membership includes leading international companies from across the carbon trading cycle. IETA members seek to develop an emissions trading regime that results in real and verifiable greenhouse gas emission reductions, while balancing economic efficiency with environmental integrity and social equity.

As of April 2011, IETA comprises around 140 international companies from OECD and non-OECD countries. IETA has formed several partnerships including, among others, the World Bank, Eurelectric, the World Business Council for Sustainable Development (WBCSD) and the California Climate Action Registry, the Edison Electric Institute (EEI), the Electric Power Research Institute (EPRI) and the San Francisco Carbon Collaborative.

To find out more about IETA, visit **www.ieta.org**.

02 May 2013

Dear European Financial Reporting Advisory Group,

We at the Climate Disclosure Standards Board (CDSB), the International Emissions Trading Association (IETA) and other distinguished participants at a January 2013 Workshop on Financial Carbon Accounting in Edinburgh, UK[1], welcome the opportunity to put our views forward about financial accounting for emissions trading. We would very much like to see clarification of financial accounting rules for emissions trading, for the following reasons:

1) There is significant divergence in accounting practices for emission allowances across Europe and internationally, making it difficult to compare financial statements;[2]

2) There is evidence that account preparers and users would welcome clarity on emission allowance accounting rules[3]: stakeholders would respond promptly to due process requirements because they want to have a resolution;

3) The International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) have already done a considerable amount of work on the Emission Trading Schemes project, joined more recently by the French Accounting Standard setter (ANC) in 2012, and thus it would make sense to resolve the issue and bring it to completion. It should be possible to come to agreement relatively quickly and it will provide a solid basis for work on related climate change and integrated reporting issues, which will become more important to IASB's remit over the next ten years. The CDSB and IETA are willing to provide practical support and help to EFRAG and IASB, for example through drawing on our networks to commission research and/or drafting and testing voluntary guidance; and

4) Clarification of rules demonstrates the financial accounting sector's commitment to the public interest, and the need to give tangible presence to what is still a poorly formed emissions trading market.

---

[1] *Carbon Financial Accounting Workshop*, 14th-15th January 2013, University of Edinburgh, Edinburgh, Scotland. Jointly organised by an international team of academics, the CDSB, and IETA.

[2] Lovell et al (2010) *Accounting for Carbon*, ACCA and IETA, http://www.accaglobal.org.uk/content/dam/acca/global/PDF-technical/climate-change/rr-122-001.pdf; Haupt and Ismer (2011), *Emissions Trading Schemes under IFRS: towards a 'true and fair view'*, http://climatepolicyinitiative.org/wp-content/uploads/2011/12/Emissions-Trading-Schemes-under-IFRS.pdf

[3] There is evidence of an extended expectation of such guidance on the accounting for carbon allowances. For example, the 2011 Annual Report of Lafarge states that "Where the Group is involved in a cap and trade scheme, and until the IASB issues a position on the appropriate accounting treatment, the Group will account for the effects of such scheme as follows….". Likewise, most respondents to the ACCA IETA Research Report on Carbon Accounting (Lovell et al., 2010) stated that they would welcome such guidance.

We have followed the consultation document structure in providing responses to the specific questions. Our responses are summarized below, under the three main comment paper sections:

- the nature of emission rights;
- the business purpose of the rights; and
- future governance issues.

1) The nature of emission rights

Q28 - Is there a need for specific accounting guidance? Why?

We agree that there is a need for specific accounting guidance because there is a significant amount of emissions rights under the EU ETS[4]; and both value and quantity are projected to increase in the future, despite recent set-backs and price falls. Further, new carbon markets are either already operational or in the pipeline, in, for example, California, Quebec, Australia and China.[5] Our position is also supported by a substantial body of academic literature.[6] These emissions rights are material in companies' financial accounts, with recent research showing that the materiality of emission allowances in European companies is potentially in the range of 14%-85% of profit/loss before tax.[7] Further, preliminary results presented at the January 2013 Workshop on Carbon Financial Accounting (see footnote 1) show a diversity in accounting practices by companies participating in EU ETS: non-disclosure, cost method, net method, fair value method, activity-based model and further variations, with no particular method emerging as dominant in this arena. The combined effect of emission rights materiality and the lack of a dominant accounting method results in a lack of comparability of the information disclosed by companies and, consequently, in a lack of relevant information to financial report users. This fuels, in turn, policy vacillation and confusion at the point of application of environmental regulation.

Emissions rights present similarities to intangible assets and inventories but emissions rights cannot be simply classified on the basis of existing standards since their nature does not fit entirely with existing definitions, as EFRAG notes. An attempt to accommodate emissions rights within existing standards would therefore most likely result in an inappropriate representation of financial statements, as demonstrated by the diversity of accounting practices among companies participating in EU ETS. The central question is therefore what would an accounting guidance look like? Would it be principles-based? This will only be resolved by bringing together a mixed group of

---

[4] The EU ETS comprised 84% of global carbon market value in 2010, and was worth $120billion (Linacre et al, 2011, *State and Trends of the Carbon Market 2011).*
[5] Ascui (2013) paper presented at *Carbon Financial Accounting Workshop* held at Edinburgh University, UK, 14th-15th January 2013 (for details email: francisco.ascui@ed.ac.uk).
[6] See for example Engels (2009) An exploratory study of how companies learn to account for carbon *Accounting, Organizations and Society* 34: 488-498; Braun (2009) The evolution of emissions trading in the European Union – The role of policy networks, knowledge and policy entrepreneurs *Accounting, Organizations and Society* 34: 469–487; Ascui & Lovell (2011) As frames collide: making sense of carbon accounting. *Accounting, Auditing and Accountability Journal* vol 24 (8) pp.978 – 999; Bebbington and Larrinaga (2008) Carbon trading: accounting and reporting issues. *European Accounting Review* vol. 17 (4), pp. 697-717.
[7] see Lovell, H., Bebbington, J., Larrinaga, C. and Sales de Aguiar, T. (in press) Putting carbon markets into practice: a case study of financial accounting in Europe. *Environment and Planning C: Government and Policy.* The findings are based on a small subset of 8 companies (drawn from a wider survey) who provided sufficient data in their financial reports to enable us to calculate emission allowance materiality.

experts with diverse interests - reporters, assurers, investors, regulators, tax authorities and other interested stakeholders. Importantly, such a group should include experts who are familiar with carbon markets as well as financial accounting experts.

Q29 - Do you agree with the above arguments? Why?

We agree with arguments presented in Points 7-27 of the Comment Paper, concluding in Point 26 that specific accounting guidance should be developed for Emissions Trading Schemes, because a perfect analogy cannot be drawn from existing accounting guidance. Emission rights definitely have similarities with the concepts of inventory and intangible assets, but as noted they do not entirely match. It is clear that emission rights do not meet the definition of financial assets. However, under specific circumstances (explained in EFRAG § 9), when the entity does not participate directly in the EU ETS, similarities to financial assets can be found.

More specifically in relation to Point 9 - summarizing the ANC position 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), and, therefore, emission rights may not be considered as intangible assets; we consider the ANC argument to be **invalid**. The ANC observation that emission rights in the EU ETS are separate from emission permits is misleading, as it applies only to stationary installations and not to airlines, and in any case the distinction is purely an artefact of the legislative construction of the EU ETS, which does not necessarily apply in other emission trading schemes.[8] We concur in the analysis made in the EFRAG document in that the application of the definition and recognition criteria of intangible assets would result in fishing quotas being intangible assets, but would also result in emission rights meeting the three critical attributes of intangible assets mentioned in IAS 38: identifiability, control and future economic benefits. Emission rights are identifiable - they arise from a legal framework, and in practical terms each emission allowance has a unique reference number; they are controlled (owned) by the company and can be freely transferred from one owner to another; and they produce future economic benefits because they entitle the holder to exemption from a fine and therefore have value depending on the market demand for exemptions from such fines. There is no a priori reason why emission rights may not be considered as intangible assets. This was recently specifically considered and supported in the UK Court of Appeal case *Armstrong DLW GmbH v Winnington Networks Ltd*, which concluded that EU allowances satisfied all tests for intangible property. [9]

A useful starting point would be to clarify the point that 'emission rights' do not provide a right to emit greenhouse gases, but rather a right to exemption from a fine or penalty for emitting greenhouse gases.

2) The business purpose of emission rights

[8] Ascui (2013) paper presented at *Carbon Financial Accounting Workshop* held at Edinburgh University, UK, 14th-15th January 2013 (for details email: francisco.ascui@ed.ac.uk).
[9] [2012] 3 All ER 425, decided on 11 January 2012 by Stephen Morris QC, Deputy High Court judge (Chancery Division). Ghaleigh (2013) paper presented at *Carbon Financial Accounting Workshop* held at Edinburgh University, UK, 14th-15th January 2013 (for details email: n.ghaleigh@ed.ac.uk).

Q39 - Do you agree with the analysis of information needs of users for each business model?

Q40 - Do you agree that this should result in different accounting requirements?

The EFRAG Comment Paper recommends that (similarly to the ANC analysis) decisions about the appropriate financial accounting approach should give consideration to how an entity expects to use the emission right: a so called 'business model' or 'activity based' approach. We agree with this, recognizing that using emission rights for trading (e.g. by a broker/financial organisation) can and **should** be distinguished from their use for compliance (e.g. by an industrial company). It is appropriate to recognize that organizations are responding to Emissions Trading Schemes not only as a way to comply with regulations but also as a new emerging business. The existence of these two realities is important information to users of accounts. Thus, information on these two scenarios needs to be accurately and differently reflected in organizations' financial accounts. EFRAG's version would align closer with information needs rather than depicting use (which ANC's version is closer to).

However, use of a business model approach, as highlighted by EFRAG, will require some form of discipline. The challenge being that sometimes organisations do hold emission allowances with a view to both use and sale, depending on evolving circumstances, i.e. if they estimate that they will have excess allowances, they will sell. So how do you identify the allowances that will be kept and those that will be sold? Some big emitters will have a fairly dynamic approach, and the detail of how it would work in practice does need to be thought through carefully.

Q56 & Q57 – Do you agree that free allowances should be measured at fair value at inception, this fair value being their deemed cost? What arguments detailed above do you not find convincing? How do you respond to them?

We agree that free allowances should be measured at fair value at inception (with fair value being their deemed cost), as this will allow for greater visibility of initial free allowances in financial statements. Such a treatment is exactly the same in principle as already exists in the gifting of assets to related parties. We can also apply the IFRS 9 business model test: the objective of the entity's business model is to hold the financial asset to collect the contractual cash flows (rather than to sell the instrument prior to its contractual maturity to realise its fair value changes). It is true that in the ordinary course of events cash flows could not be expected from emission allowances. However, they are possible - contingent on events – and therefore would meet the definition and recognition criteria of contingent assets and liabilities. Any accounting guidance should follow suit.

Q70 - Determining the nature of the credit if free allocations are measured at fair value

In response to Points 64-69, we agree that there should be no recognition of Day-1 gain, and we do not believe there should be recognition of deferred income. We recommend the best option as Other Comprehensive Income (OCI) (as outlined in Point 68). This is because it would allow companies to recognize emissions rights (including free initial allocation) in the financial statements/income statements without affecting profit and loss. In addition, in case of possible fluctuations, emissions rights recognition would not affect results achieved in the profit and loss.

Q76 - 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?

We agree that separate presentation of asset and liability provides more relevant information. The analogy with the IAS 32 requirement to offset financial assets and financial liabilities is not applicable because it has been noted that emission rights cannot be considered financial instruments for the companies participating in the EU ETS and, as explained in EFRAG's analysis, the entity's net position in the EU ETS cannot be settled in cash (however, cash settlement is a valid compliance option in certain other emissions trading schemes, and any guidance should also consider this possibility).

Q77 - 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)?

We agree that derecognition of liabilities before surrender affects an entity's financial position. The impact will be significant if emissions rights are material. Thus, providing updated and accurate information over the accounting period on how organizations are progressing towards their emissions cap, is important.

Q78 (a) & (b) - 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?

We agree that the obligation to the Regulator has definite economic value from the moment that there is a market operating. Under an Emissions Trading Scheme the participating company holds control over measures that could reduce its emissions and, therefore, the act of emitting has (at least) an opportunity cost derived from the obligation to surrender rights that could be otherwise be marketed. Likewise, if the company is short of rights, then emissions have an economic value equal to the cost of new rights to be purchased in the market. Emissions produced by organizations, and the cap they need to observe during the trading period, are therefore extremely relevant information to be recognized in the financial statements. Net liability presentation does not provide sufficient information for account users to judge whether entities are using free initial allowances for other purposes aside from compliance.

It is also important to consider that the time interval for financial statement production is different from the period that EU ETS operates, so emissions surrender has not typically occurred when financial statements are produced. In addition, this information is relevant to users because the monetary value involved in this pollution is material (see footnote 4). Thus, the possibility of non-surrender of emissions rights may compromise an entity's future operation. The exclusion of information on assets and liabilities related to emissions rights may also compromise assumptions on an entity's going concern.

Q88 – Do you agree or disagree with EFRAG's proposal on the subsequent measurement of assets and liabilities? Why?

We agree with EFRAG's proposal on the subsequent measurement of assets and liabilities. The use of weighted average cost will allow the cost of emissions rights to be periodically actualised. In case of fluctuations, the use of weighted average cost will allow the changes in emission rights values to be less volatile than with the use of 'first-in-first-out'. However, there is a need for caution since there is no clear and global definition of how to measure greenhouse gas emissions within a company. Nevertheless, as most emissions trading schemes are accompanied by mandatory greenhouse gas reporting rules, emission measurements should be reasonably consistent at least within the scope of a given scheme.

Q102 - Which of the above alternatives would you support? Please explain why.

Limited transfer is an acceptable option for dealing with transfers between trading and compliance portfolios. It gives organizations the flexibility to provide information on emissions rights they might negotiate before surrender. This approach would be especially important for organizations if the initial acquisition of emissions rights were auctioned. A limit on the size of transfers would probably avoid the risks of companies not surrendering rights properly at the end of period.

3) Future governance issues

Q107 – What would you like IASB to do?

For the IASB going forward we recommend a combination of Option A (research project) and B (developing a standard). We do not, on balance, endorse Option C (IFRS Interpretations Committee working on an interpretation), as it did not work in the past, and the noted limitations of existing standards will not easily accommodate Emissions Trading Schemes. Options A and B in tandem therefore seem to be a good alternative route forward. As noted, Emissions Trading Schemes are expanding rapidly and it is imperative to develop a standard as soon as possible. Current setbacks in the EU ETS, whilst concerning, do not negate the point that carbon markets continue to be a significant and ongoing policy measure in the response to climate change, both in the EU and in many other countries. Supporting research could be carried out at the same time as developing a standard. Suitably framed research could usefully explore, for example, the uptake of a new standard, and/or track changes in international Emission Trading Schemes procedures in order to integrate any changes into accounting standards.

Yours sincerely,

Lois Guthrie
Executive Director, CDSB

Dirk Forrister
CEO and President, IETA

Heather Lovell
University of Edinburgh

Thereza Raquel Sales De Aguiar
Heriot-Watt University Edinburgh

Augustin Entonu
London School of Business and Finance

Lorna Stevenson
University of St Andrews

Carlos Larrinaga
Universidad de Burgos

Francisco Ascui,
University of Edinburgh