

IFRS Briefing Sheet

Publication of IFRIC 3 *Emission Rights*

Issue 16

This *Briefing Sheet* discusses the International Financial Reporting Interpretations Committee's (IFRIC's) recent publication of IFRIC 3 *Emission Rights*. Several governments either have, or are in the process of developing, schemes to encourage reduced emissions of pollutants. IFRIC 3 provides guidance for accounting for schemes involving "cap and trade" emission rights under International Financial Reporting Standards (IFRSs).

IFRIC 3 requires an entity participating in such a scheme to recognise rights received as intangible assets and recognise liabilities for its obligation to deliver allowances as emissions are produced. It also requires recognition of a government grant in some cases.

Scope

The interpretation provides guidance on how to account for 'cap and trade' emission rights schemes. These schemes normally have the following features:

- an entity participating in the scheme has to reduce its emissions to a specified level (the 'cap') and it receives allowances from the government equal to its cap;
- entities are free to buy and sell allowances; and

- at the end of the compliance period the entity's emissions are verified and the entity must deliver allowances equal to its actual emissions.

IFRIC 3 deals with the accounting by participants for cap and trade schemes that are operational. This interpretation applies to entities participating in these schemes, but not to brokers or other position-taking institutions to which allowances are not issued.

The guidance in IFRIC 3 was developed for cap and trade schemes, but the IFRIC notes that these requirements may be applicable to other schemes that are designed to reduce emission levels.

Requirements

The IFRIC concluded that a cap and trade scheme gives rise to:

- an intangible asset for allowances held;
- a government grant for the difference between the amount paid and the fair value of the allowances when allowances are issued for less than fair value; and
- a liability for the obligation to deliver allowances equal to the entity's actual emissions during the compliance period.

**A supplement to KPMG's
publication IFRS in Brief**

An entity may not offset the assets and liabilities or account only for its net exposure.

Allowances, whether issued by the government or purchased, are intangible assets and should be accounted for under IAS 38 *Intangible Assets*. Allowances that are issued for less than fair value are measured initially at fair value. Any difference between the amount paid and the fair value is a government grant and should be recognised initially as deferred income in the balance sheet and subsequently recognised as income on a systematic basis over the compliance period for which the allowances were issued, regardless of whether the allowances are sold subsequently.

IFRIC 3 notes that for most allowances traded in an active market, no amortisation would be required, because the residual value would be the same as its cost (or revalued amount) and hence the depreciable amount would be zero.

As emissions are made, an entity should recognise an obligation to deliver allowances equal to the emissions that have been made. This obligation should be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. Usually this will be equal to the current market price of the allowances required to settle the obligation.

If the allowances are accounted for using the revaluation model under IAS 38, then the balance of the

revaluation surplus at the date the entity settles its obligation under the scheme should be transferred directly to equity. This accounting treatment precludes any recycling of fair value increases related to the allowances through the income statement.

Conversely, if the entity accounts for its allowances under the cost method, then any difference between the carrying amount of the asset and the liability will be recognised in profit or loss upon settlement of the obligation.

If the market value of the allowances falls below its cost, or other indicators of impairment exist, then the guidance in IAS 36 *Impairment of Assets* should be followed to determine whether the assets are impaired.

An example accompanies IFRIC 3 to illustrate the accounting for cap and trade schemes.

Effective date and transition

Entities must apply this interpretation for annual periods beginning on or after 1 March 2005. Earlier adoption is encouraged.

Changes in accounting policies must be accounted for under the transition requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Development of the interpretation

The IFRIC published its draft interpretation D1 *Emission Rights* in May 2003. In its redeliberations, the IFRIC had decided to modify the approach proposed in D1 to address some of the concerns raised by respondents about mismatches in

profit and loss for the measurement of assets and liabilities under IFRIC D1. The IFRIC suggested, and the IASB tentatively had agreed, to pursue a limited amendment of IAS 38 to require currency-like intangibles such as emission rights certificates to be measured at fair value through the income statement. However, in December 2003 the International Accounting Standards Board (IASB) suggested that the IFRIC not proceed with the interpretation until the IASB had finalised its project on accounting for government grants since IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* is one of the principal references for IFRIC 3. The European Union Emissions Trading Scheme came into force at the beginning of 2005. After the IASB's project addressing IAS 20 was delayed, the IFRIC decided that an interpretation should be finalised because the need for timely guidance outweighed the disadvantages of proceeding with the interpretation and the IFRIC voted to finalise an interpretation based on D1.

The IFRIC noted that when the IASB amends IAS 20, any required modifications to the interpretation would be dealt with as a consequential amendment arising from the amended standard. The IFRIC also will pursue the limited amendment to IAS 38 as a follow up to IFRIC 3.

If you would like further information on any of the matters discussed in this issue of *IFRS Briefing Sheet*, please talk to your usual local KPMG contact or call any of our member firms' offices.

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