Project	**Emissions Trading Schemes**
Topic	**Accounting for the items in a voluntary scheme**

Purpose

1. The purpose of this paper is to discuss the accounting for cap & trade schemes with *voluntary* participation. The paper (a) describes the items that an entity exchanges when it becomes a member of a scheme with voluntary participation and (b) discusses which items meet the element definitions in the boards' frameworks. The paper does not address (a) the criteria for recognition (b) measurement and (c) presentation of the elements in a voluntary scheme.

2. The paper includes questions for the boards (paragraphs 42, 60) that will give staff direction in developing accounting guidance for emissions trading schemes. However, the paper does not ask the boards to make any decisions at this meeting.

Introduction

3. Cap & trade schemes can be classified as (a) schemes with voluntary participation or (b) statutory schemes with mandatory participation. The paper uses the term *voluntary scheme* for schemes with voluntary participation even though the schemes no longer include voluntary features once an entity is a member of a scheme.

4. The paper discusses the items that an entity exchanges when it becomes member of a voluntary scheme although statutory schemes with mandatory participation

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The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

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are more prevalent. The paper focuses on voluntary schemes for the following reasons:

(a) voluntary schemes are in the scope of the Emissions Trading Schemes project.

(b) voluntary schemes have relevance. The voluntary scheme of the Chicago Climate Exchange, for example, has more than 300 members—among them Ford Motor Company, IBM and Motorola.

(c) membership in a voluntary scheme results from a contract between knowledgeable, willing parties. In contrast, statutory schemes result from a unilateral decision by a government (or governmental body).

5. The staff find it easier to analyse the accounting for items when the items arise from a contract. This is because a contract provides an unambiguous anchor, establishing rights and obligations at the time when the contract comes into existence. Participation in a statutory scheme does not result from a contract between willing parties, making the analysis of rights and obligations more complex.

6. The staff do not take a view at this stage on whether any of the conclusions reached for voluntary (ie contractual) schemes can be applied to statutory (ie non-contractual) schemes. However, staff believe the discussion of voluntary schemes to be helpful in structuring the discussion of statutory schemes. Statutory schemes and the differences between statutory schemes and voluntary schemes are discussed in more detail at the end of this paper (paragraphs 61 - 64).

Voluntary schemes

7. In entering a voluntary scheme, members make a legally binding commitment intended to reduce their emissions compared to the level of historic emissions. Members commit to comply with the requirements of the scheme for the duration of the commitment period. That means once an entity has signed up as a member, the scheme no longer includes voluntary features.

8. When an entity signs the contract to become a member of a voluntary scheme the entity receives two items:

   (a) membership in the scheme, and

   (b) right to an allocation of emissions allowances (ie right to receive a specified amount of emissions allowances)

9. In exchange for the items received, a member of the scheme incurs membership obligations. Each member promises to pay one emissions allowance for each unit of emissions that occurs during the commitment period. That means the promise to pay allowances is the consideration paid in exchange for the items received (ie membership in the scheme and right to an allocation).

10. The first item that a member of a voluntary scheme receives is the membership. Membership in a voluntary scheme may provide several benefits.[1] Members, for example, may use their membership as a means to prove concrete action on climate change to their stakeholders. One potential benefit could be to attract an environmentally focused customer base. Beyond that, membership may allow the member to establish early a track record in emissions reductions and gain experience with emissions trading schemes in light of pending legislation.

11. The second item that a member of a voluntary scheme receives is the right to an allocation of allowances. The allocation represents a level of *allowable emissions* up to which a member may emit without incurring costs of emitting. The level of allowable emissions is typically below the level of historic emissions and reflects an entity's emissions target. The allowances issued under an allocation take the form of tradable items. The scheme administrator typically establishes an exchange that facilitates buying and selling allowances.

12. For administrative reasons, the commitment period of a voluntary scheme is often split into annual compliance periods. That means an entity (a) receives the allowances under its allocation in yearly instalments at the beginning of each compliance year and (b) offsets its emissions that occur in a compliance year at

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[1] For a more comprehensive list of benefits refer, for example, to the website of the Chicago Climate Exchange (http://www.chicagoclimatex.com/content.jsf?id=821)

the end of that compliance year. Members offset their emissions by surrendering allowances equal to their emissions units to the scheme administrator. It is of note that the possibility of benefiting from the schemes by retaining surplus allowances is, for most entities, of minor importance. In fact, it is likely that a considerable number of members will end up with excess emissions (ie their level of emissions exceeds their allocation). The idea of reducing emissions by establishing a trading mechanism relies on the assumption that some members will experience a net outflow of allowances. Otherwise, there would be abundant supply of allowances and the market would collapse.

13. The following example will be used throughout the paper:

> On 1 January 2010 an entity becomes a member of a voluntary scheme with a one year commitment period, starting on 1 January 2010. The entity is entitled to an allocation of 100 allowances. The allowances that result from the allocation are issued on 1 January 2010.
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> In exchange for the membership in the scheme and the right to an allocation, the entity promises to pay one allowance for each unit of emissions occurring during the commitment period. The entity estimates it will emit 110 units of emissions during the commitment period. That means the entity expects that its demand for allowances will exceed its allocation of 100 allowances by 10 units. The entity plans to make up the expected shortfall by acquiring allowances on the market.

Do the items received in the scheme meet the asset definition?

14. An entity receives two items in a voluntary scheme: (1) membership in the scheme and (2) right to an allocation of allowances. The accounting issue is whether these items meet the asset definition in the IASB *Framework* and the FASB *Statement of Financial Accounting Concepts No. 6*. The IASB *Framework* defines assets as follows:

> An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. [paragraph 49]

15. FASB *Concepts Statement 6* defines assets as follows:

> Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [paragraph 25]

16. *Membership in the scheme* creates a resource because it may be used singly or in combination with other assets in the distribution of goods or services to be sold by the entity. An entity may, for example, use the membership rights to improve the credibility of the entity's reputation and (indirectly) support its sale activities. Proving climate action may attract an environmentally focused customer base. The membership resource is controlled as a result of a past event, evidenced by the existence of a legally binding contract. Future economic benefits from the membership are expected to flow to the entity, for example, in form of higher sales prices and/or increased sales volumes. Hence, there is support for the membership in the scheme to meet the asset definition in the boards' frameworks.

17. The second item that a member receives is the right to an allocation of allowances. The allowances that result from an allocation are typically issued in yearly instalments to entities at the beginning of each compliance year. Hence, an allocation comprises (a) allowances that have been received (hereafter, allowances received) and (b) the right to future instalments for each remaining compliance year within the commitment period. Whereas there is little doubt that *allowances received* meet the asset definition, there is more debate as to whether, and when, a *right to future instalments* creates an asset. The right to future instalments will be discussed later in the paper (paragraphs 54 - 59).

18. In the example used in this paper, the entity obtains the following items on 1 January 2010 as result of participation in the scheme:

> The member holds (a) membership in the scheme and
> (b) 100 allowances (issued on 1 January 2010).
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> (The entity holds no right to future instalments in the example. This is because the commitment period lasts only one year and hence, is not split into several compliance periods. As a result no right to future instalments arises in the example.)

Do the membership obligations in a voluntary scheme meet the liability definition?

19. In exchange for the items received, a member of the scheme incurs membership obligations. Each member promises to pay one allowance for each unit of emissions that occurs during the commitment period. The accounting issue is whether, and when, the promise to pay one allowance for each unit of emissions meets the definition of a liability in the boards' frameworks. The IASB *Framework* defines a liability as follows:

> A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. [paragraph 49]

20. FASB *Concepts Statement 6* defines a liability as follows:

> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [paragraph 35]

21. The promise to pay one allowance per emission results from the membership in the scheme and hence, arises from a past event. However, it is less clear whether the promise to pay one allowance per emission creates a present obligation for an entity *before* the entity has emitted. Specifically, does an entity have a present obligation if a future outflow (sacrifice) of allowances is contingent on an entity's future actions? The decision as to what creates the obligating event, arguably, is the most contentious issue in the accounting for the items in a voluntary scheme. The boards' view on this issue will have

significant impact on the timing of the recognition of liabilities in a voluntary scheme.

22. The IASB *Framework* and FASB *Concepts Statement 6* do not specifically address the accounting for those future outflows of resources embodying economic benefits that are contingent on an entity's future actions. FASB *Concepts Statement 6*, however, spells out further the characteristics of a liability. For an item to meet the liability definition it is essential that it leaves the entity 'little or no discretion to avoid the future sacrifice' (paragraph 36 of FASB *Concepts Statement 6*). Some may interpret this to mean that future outflows that are contingent on an entity's future actions do not meet the essential characteristics of a liability. This is because, arguably, an entity can avoid the future sacrifice by its future actions.

23. The accounting for outflows that are contingent on an entity's future actions is addressed in other IFRSs and U.S. GAAP literature. The following paragraphs discuss two views as to what creates the obligating event in a voluntary scheme:

    (a) *View 1*: A member's actual emissions create the obligating event. A member of a voluntary scheme does not incur a present obligation until it has emitted. Until emissions have occurred, the member can avoid the outflow of allowances by its future actions.

    (b) *View 2*: The membership contract creates the obligating event. A member incurs a present obligation as result of becoming a member of a scheme. As of signing the membership contract, the obligation to pay allowances is unconditional. Only the amount of allowances due under the membership contract is uncertain.

24. The paper illustrates View 1 by reference to the guidance in (a) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (b) FASB Statement No. 143 *Asset Retirement and Environmental Obligations* [FASB ASC Topic 410][2]. View 2 is illustrated by reference to (a) IFRS 3 *Business*

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[2] The paper refers several times to the basis for conclusions of FASB Standards. Staff, therefore, consistently refer to the Pre-Codification Standards throughout the paper.

Combinations and (b) FASB Statement No. 141(R) *Business Combinations* [FASB ASC Topic 805]. (See also the additional examples in paper 13b / memo 4b supporting either View 1 or View 2.)

View 1

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

25. IAS 37 applies to the accounting for provisions. A provision is defined as a liability of uncertain timing or amount (paragraph 10 of IAS 37). In identifying a provision in the scope of IAS 37, the standard interprets the liability definition in the IASB *Framework* as follows:

> A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:
>
> (a) where the settlement of the obligation can be enforced by law; or
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> (b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation. [paragraph 17]

26. Hence, for the promise to pay allowances to create an obligating event in the scope of IAS 37, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. Importantly, IAS 37 further specifies:

> It is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity. Similarly, an entity recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no

> present obligation for that future expenditure and no provision is recognised. [paragraph 19]

27. Applying the guidance in IAS 37 to voluntary schemes, one could view a member's actual emissions as the obligating event in a voluntary scheme. Until a member has actually emitted, the obligation to pay allowances is *dependent* on a member conducting its emitting business. The scheme administrator could not enforce settlement of the obligation before the entity has actually emitted. Stated differently, the administrator could not fine or make the member take action related to its future emissions at the time when the member makes the promise to pay allowances in a voluntary scheme.

28. The fact that a member may be economically compelled to emit in the future does not mean that it has a present obligation according to the guidance in IAS 37. Paragraph 19 of IAS 37 concludes that commercial pressure or legal requirements to operate in a particular way in the future do not create a present obligation. Hence, some think that a promise to pay allowances does not create a liability under IAS 37 before the entity has actually emitted (unless the contract becomes onerous). The entity has a liability only when it has emitted since until that point the obligation is conditional on the member continuing to emit.

29. The Exposure Draft of *Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits* (hereafter, ED IAS 37) proposes to amend the accounting for obligations that are conditional on the occurrence of a future event.[3] ED IAS 37 results in an entity recognising a liability even if the related outflow of economic resources is conditional on the occurrence or non-occurrence of a future event. Uncertainty about the future event is not viewed as a recognition criterion as in IAS 37 but is reflected in the measurement of the liability recognised. ED IAS 37 proposes that

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[3] According to the current guidance in IAS 37, an entity does not recognise a contingent liability. A contingent liability is a possible obligation that is contingent on the occurrence or non-occurrence of a future event not wholly within control of the entity.

> […] an entity has a liability even though the amount that will be required to settle that liability is contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. In such cases, an entity has incurred two obligations as a result of a past event—an unconditional obligation and a conditional obligation. [paragraph 22]

30. However, ED IAS 37 notes that 'only present obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) result in liabilities' (paragraph 17). Arguably, the obligation to surrender an amount of allowances to the scheme administrator does *not* exist independently of an entity's future actions. Hence, ED IAS 37 seems not to affect the analysis under IAS 37 as to whether, and when, a promise to pay allowances gives rise to a liability.

31. Staff engaged with different IASB members and other staff to make sure that the analysis in this section reflects the current understanding of the guidance in (a) IAS 37 and (b) ED IAS 37. The interpretation in this section is consistent with how the IAS 37 project team would apply IAS 37 and ED IAS 37 to the promise to pay allowances.

32. Staff have considered whether there is an alternative view, specifically, with regard to interpreting ED IAS 37. The staff considered whether signing the membership contract can be viewed as the obligating event in a voluntary scheme because the promise to pay allowances is unconditional as of that point. However, staff discarded that view based on the wording in IAS 37 / ED IAS 37 and as result of discussions with the IAS 37 project team.

FASB Statement No. 143 Asset Retirement and Environmental Obligations

33. Statement No. 143 applies to legal obligations associated with the retirement of a tangible long-lived asset. The standard requires an entity to recognise the fair value of a liability for an asset retirement obligation in the period in which it is incurred. Statement No. 143 specifies the obligating event in the Basis for Conclusions:

> The definition of a liability distinguishes between present obligations and future obligations of an entity. Only present obligations are liabilities under the definition, and they are liabilities

> of a particular entity as a result of the occurrence of transactions or other events or circumstances affecting the entity. [paragraph B31]

34. Paragraph B31 of Statement No. 143 notes that identifying the obligating event is often difficult and goes on illustrating this with decontamination of a nuclear power facility:

> For example, in the case of an asset retirement obligation, a law or an entity's promise may create a duty or responsibility, but that law or promise in and of itself may not be the obligating event that results in an entity's having little or no discretion to avoid a future transfer or use of assets. An entity must look to the nature of the duty or responsibility to assess whether the obligating event has occurred. For example, in the case of a nuclear power facility, an entity assumes responsibility for decontamination of that facility upon receipt of the license to operate it. However, no obligation to decontaminate exists until the facility is operated and contamination occurs. Therefore, the contamination, not the receipt of the license, constitutes the obligating event. [paragraph B31]

35. Importantly, it is the actual contamination, not the receipt of the license that constitutes the obligating event. Hence, the responsibility for decontamination does not create an obligation until contamination occurs. In a voluntary scheme, one can argue that an entity assumes responsibility for paying allowances upon receipt of the membership. However, no obligation to pay allowances exists until the emitting installations are operated and emissions occur according to the guidance in Statement No. 143. Hence, applying Statement No. 143 by analogy means that the promise to pay allowances does not create an obligation until emissions occur. That is, the actual emissions and not the membership contract constitute the obligating event.

View 2

IFRS 3 Business Combinations */ FASB Statement No. 141(R)* Business Combinations

36. IFRS 3 / Statement No. 141(R) address the accounting for the assets acquired and liabilities assumed in a business combination. If an acquirer has an obligation to make payments to the former owner of the acquiree and those payments are contingent on a specified future event (hereafter, contingent consideration), IFRS 3 / Statement No. 141(R) require the acquirer to recognise

that obligation as a liability (provided the item is not classified as equity). The Basis for Conclusions on IFRS 3 / Statement No. 141(R) notes:

> In developing the 2005 Exposure Draft, both boards concluded that the delayed recognition of contingent consideration in their previous standards on business combinations was unacceptable because it ignored that the acquirer's agreement to make contingent payments is the obligating event in a business combination transaction. Although the amount of the future payments the acquirer will make is conditional on future events, the obligation to make them if the specified future events occur is unconditional […]. [paragraph BC346]

37. Often, the payment of contingent consideration following a business combination is contingent on an entity's future actions. The agreement could, for example, require the acquirer to make additional payments on the basis of revenue or earnings levels in a specified period.[4] Importantly, IFRS 3 / Statement No. 141(R) view the obligating event as the acquirer's agreement to make contingent payments, not the occurrence of the specified event. The payments in a voluntary scheme are similar in that they are contingent on an entity's future actions. The number of allowances payable is based on an entity's emissions during the commitment period. Applying the guidance in IFRS 3 / Statement No. 141(R) by analogy means the promise to pay allowances in a voluntary scheme is unconditional and hence, creates a present obligation that gives rise to a liability. Only the amount of the ultimate payment is uncertain.

38. The settlement of the promise to pay allowances in a voluntary scheme results in an outflow of resources embodying economic benefits. This applies irrespective of whether the promise is settled before the entity starts emitting. An entity may settle the promise it has made, for example, by agreeing with the scheme administrator to unwind the membership in the scheme. Presumably, the scheme administrator will accept unwinding the membership only if the entity surrenders at least the amount of allowances it received with the allocation. Some might argue that the need for this outflow supports the conclusion that the

[4] IFRS 3 / Statement No. 141(R) treat all contingent consideration in the same way, regardless of whether the event that triggers payment is within the acquirer's control.

promise itself creates a present obligation. Others, however, object to this view. They argue that the entity would surrender the allowances upon settlement of the promise but would receive back its right to emit freely without payment (which was not recognised as a separate asset before the entity became a member of the scheme). They conclude that no net outflow arises, assuming that the exchanged items are of equal value.

39. Summing up, the application of the guidance in both (a) IAS 37 / Statement No. 143 and (b) IFRS 3 / Statement No. 141(R) means that a liability results from participation in a voluntary scheme. However, IAS 37 / Statement No. 143 and IFRS 3 / Statement No. 141(R) differ in *when* the items in a scheme give rise to a liability:

    (a) Applying the IAS 37 / Statement No. 143 approach, a member of a voluntary scheme does not incur a present obligation until it has emitted. Until emissions have occurred, the member can avoid the outflow of allowances by its future actions.

    (b) Applying the IFRS 3 / Statement No. 141(R) approach, a member incurs a present obligation to pay allowances as result of becoming a member of a scheme. As of signing the membership contract, the obligation to pay allowances is unconditional. Only the amount of the ultimate payment is uncertain.[5]

40. Importantly, an entity's ability to avoid the outflow of future expenditure by its future actions is not relevant in determining whether a liability exists applying the guidance in IFRS 3 / Statement No. 141(R). Instead, the uncertainty surrounding the ultimate outflow of resources (including the effect of the entity's ability to avoid the outflow) affects the measurement of the liability. That means IFRS 3 / Statement No. 141(R) do not make an entity's ability to avoid future expenditure a recognition criterion but a measurement issue.

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[5] The obligation to pay allowances reflects the estimated emissions during the current compliance period (and not during the longer commitment period) if one views the right to future instalments and the promise to pay allowances in future compliance periods as an executory contract. See paragraph 54 - 59 for a discussion of the right to future instalments.

41. To illustrate the differences between (a) the IAS 37 / Statement No. 143 approach and (b) the IFRS 3 / Statement No. 141(R) approach, consider the entity's liabilities in a voluntary scheme in the above example on 1 January 2010:

> Applying the guidance in IAS 37 / Statement No. 143 an entity has a scheme liability on 1 January 2010 only if, and to the extent that, the entity has emitted on 1 January 2010.
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> Applying the guidance in IFRS 3 / Statement No. 141(R) an entity has a liability on 1 January 2010 that reflects the promise to pay allowances throughout the commitment period. The entity estimates it will pay 110 allowances for the one year commitment period. The liability exists irrespective of whether the entity has already emitted.

42. Questions for the boards:

> **Questions for the boards**
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> 1. Do you have any comments on how the staff applied the guidance in **IAS 37 / Topic 410 (formerly Statement No. 143)** to the promise to pay allowances in a voluntary scheme? Which parts of the analysis do you disagree with and why?
> 2. Do you have any comments on how the staff applied the guidance in **IFRS 3 / Topic 805 (formerly Statement No. 141(R))** to the promise to pay allowances in a voluntary scheme? Which parts of the analysis do you disagree with and why?

Staff analysis of the IAS 37 / Statement No. 143 approach and the IFRS 3 / Statement No. 141(R) approach

43. The staff think the differences between IAS 37 / Statement No. 143 and IFRS 3 / Statement No. 141(R) primarily result from the standards applying a different unit of account to items in the scope of the standards.

IAS 37 / Statement No. 143 (View 1)

44. Applying the IAS 37 / Statement No. 143 approach, emitting is the obligating event that results in the promise to pay allowances to create a separate unit of account (ie a separate liability). Proponents of the IAS 37 / Statement No. 143

approach acknowledge that the promise to pay allowances is expected to result in an outflow from the entity of resources embodying economic benefits. Nevertheless, in their view, the promise to pay allowances does not create a liability before actual emissions have occurred. They view the promise to pay allowances as affecting the cash flows that result from a member's *related* assets. A member's related assets can no longer benefit from free emitting. Stated differently, a member forfeits some of the rights related to its assets when it becomes a member of a voluntary scheme.

45. Hence, on this view, until the entity has emitted, the promise to pay allowances forms a unit of account with a member's related assets. However, the increase of outflows that results from the promise to pay allowances will typically not affect the measurement of the carrying amount of the related assets (unless an impairment occurs). This is because the related assets are likely to be carried at historical cost adjusted for depreciation or amortisation and impairment. Likewise, the promise to pay allowances will not result in derecognition of some parts of the related assets.

IFRS 3 / Statement No. 141(R) (View 2)

46. IFRS 3 / Statement No. 141(R) apply a different unit of account. IFRS 3 / Statement No. 141(R) view the contract to make contingent payments in a business combination as creating a separate unit of account (ie a separate liability) even before the contingencies are resolved. This applies irrespective of whether resolving the contingencies is dependent on an entity's future actions. Applying the guidance in IFRS 3 / Statement No. 141(R) by analogy to voluntary schemes means that the contractual obligation to pay allowances creates a separate unit of account (ie a separate liability) even before an entity has started emitting. That means the promise to pay allowances creates a separate liability as of contract inception.

Unit of account to group the financial effects of transactions

47. The boards' frameworks provide no guidance to determine the appropriate unit of account to group the financial effects of transactions into classes (ie assets,

liabilities…). In the absence of guidance to group the effects of a voluntary scheme, judgement is required in developing an accounting guidance. To be consistent with the boards' frameworks, accounting should result in information that faithfully represents the associated transactions.

48. To determine whether accounting faithfully represents a transaction it is useful to consider the interactions between the linked items that result from the transaction. In a voluntary scheme the promise to pay allowances interacts with the items received. Importantly, the assets that result from participation in the scheme (ie membership in the scheme and right to an allocation) are not dependent on the member's future actions. That means the items received create assets as of contract inception.[6]

49. Applying the approach in IAS 37 / Statement No. 143 results in timing differences as to *when* the membership contract creates separate assets and liabilities. This is because the promise to pay allowances forms a unit of account with a member's related assets at contract inception before the entity has emitted. (Related assets are those assets that no longer have the right to freely emit.) Over the course of the commitment period, the promise to pay allowances gradually creates a separate liability (ie detaches from the related assets) as the entity emits. The gradual creation of a separate liability creates a timing difference because the items received (ie membership in the scheme and right to an allocation) create separate assets as of contract inception.

50. On the other hand, the approach in IFRS 3 / Statement No. 141(R) does not result in a timing difference as to the creation of assets and liabilities when applied to voluntary schemes. This is because signing the membership contract simultaneously creates separate assets (ie membership in the scheme and right to an allocation) and liabilities (ie promise to pay allowances).

51. Assuming that the assets and liabilities that arise from participation in the scheme meet the recognition criteria and are recognised at positive amounts, the

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[6] Except the right to future instalments if it is viewed as not creating an asset before the contingencies are resolved. See paragraphs 54 - 59 for a discussion of the right to future instalments.

application of (a) the IAS 37 / Statement No. 143 approach or (b) the IFRS 3 / Statement No. 141(R) approach is likely to result in timing differences in the statement of income. This is because the two approaches employ different measurement bases to the promise to pay allowances before an entity has emitted. If the promise to pay allowances is considered to form an integral part of the related assets before the entity has emitted (ie IAS 37 / Statement No. 143 approach), the promise is reflected in the carrying amount of the related assets. Provided the related assets are measured at cost, the promise to pay allowances does not affect the statement of income before an entity has emitted (unless the related assets are impaired).[7]

52. Hence, the IAS 37 / Statement No. 143 approach results in later recognition of emissions expenses than recognition of income from initially recognising the scheme assets. This results in a gain at inception of the contract and that gain subsequently reverses (partly or completely) when the entity emits throughout the commitment period. On the other hand, if the promise to pay allowances creates a separate liability before an entity has emitted (ie IFRS 3 / Statement No. 141(R) approach) the promise to pay allowances affects the statement of income simultaneously with the assets that arise from participation in the scheme.

53. The simplified example in the Appendix illustrates the effects of the IAS 37 / Statement No. 143 approach and the IFRS 3 / Statement No. 141(R) approach at inception of the membership contract. The example is for illustration purposes *only* and is not meant to prejudge any decisions of the boards.

Right to future instalments

54. This section addresses the accounting for a member's right to future instalments in a voluntary scheme. Whereas there is little doubt that allowances received

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[7] It is also not likely that the transaction results in an onerous contract. This, at least, applies to IFRSs. In the IFRIC Update December 2003, the IASB clarified that if a contract becomes onerous as a result of an entity's own actions, no liability is recognised until that action occurs.

create assets, there is more debate as to whether, and when, the right to future instalments meet the asset definition. This is because the right to future instalments is typically contingent on the member continuing its emitting operations. If a member ceases its emitting operations in a compliance year, it is no longer entitled to receive allowances under following years' instalments. Hence, the receipt of allowances is contingent on the occurrence of a future event.

55. Consider the example introduced in paragraph 13 but assume that the commitment period runs five years (instead of one) and that an entity's allocation increases accordingly:

> The five year commitment period is split into five annual compliance periods with the first compliance period starting on 1 January 2010. The entity is entitled to a total allocation of 500 allowances that is issued in five successive instalments on 1 January in each compliance year (ie 100 allowances per year). Each instalment is contingent on the entity continuing its emitting operations until the end of the year that precedes the issue. For example, if the entity ceases its emitting operations on 30 June 2010 it is no longer entitled to receive 100 allowances on 1 January 2011 (and thereafter).

56. There are two different views on whether a right to future instalments that is contingent on the member continuing its emitting operations meets the asset definition in the boards' frameworks. The views conclude differently on whether, and when, a member *controls* a resource. One view is that a member does not control a resource until the entity's right to the unissued allowances is no longer contingent on the member continuing its emitting operations. Before that, the member has an expectation that it will receive allowances but does not yet control the resource associated with the allowances. Hence, if a right is contingent on the member continuing its emitting operations, that right does not meet the definition of an asset according to this view.

57. Others, although acknowledging that the receipt of allowances is contingent, take the view that a right to an instalment creates an asset. The right to future instalments arises from agreeing to the membership in the scheme (the past event). According to this view, the member does not control the allowances

resulting from future instalments but does control a resource being the option to obtain allowances under the future instalments. The member, arguably, has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The member can use the allowances that result from future instalments to offset emissions obligations or can sell them in the market. According to this view, the uncertainty surrounding the receipt of allowances does not negate the existence of an asset but is a measurement issue.

58. Summing up, there is support for the view that an entity receives two distinct assets when it becomes a member of a voluntary scheme: the membership in the scheme and the right to an allocation. As regards the allocation, there are two different views on whether (a) only the allowances received meet the asset definition or (b) the right to future instalments (ie the option to obtain allowances) also meets the asset definition.

59. These conclusions can be summarised in the context of the example used in this paper:

> On 1 January 2010, the member holds (a) membership in the scheme and (b) 100 allowances for the 2010 compliance year. There is support for the membership in the scheme and the allowances received to meet the asset definition (see paragraphs 16 - 17).
>
> The entity, in addition, has a right to instalments for the four remaining compliance years (representing 400 allowances) that is contingent on the member continuing its emitting operations. The right to future instalments may, or may not, meet the asset definitions in the boards' frameworks depending on whether the view in paragraph 56 or 57 is adopted.

60. Question for the boards:

Question for the boards
1. Do you have any comments on the staff analysis of the right to future instalments in a voluntary scheme? Which parts of the analysis do you disagree with and why?

Statutory cap & trade schemes

61. The paper discussed the accounting for the items in a *voluntary* scheme. This is because the membership contract provides an unambiguous anchor to discuss the items in a cap & trade scheme with voluntary participation (see paragraphs 4 - 5). However, staff point out that *statutory* schemes with mandatory participation are far more important than *voluntary* schemes in terms of market prevalence.

62. Statutory schemes are similar to voluntary schemes in that they require participating entities to offset their emissions by surrendering emissions allowances (either those allowances originally allocated and/or additional purchases). Entities that are in the scope of a statutory scheme must typically apply for a permit to emit before they start operating the regulated activities (some view the permit to emit in a statutory scheme as similar to the membership in a voluntary scheme). Once entities have received a permit under a statutory scheme, they are entitled to receive free allowances. The permit to emit is distinct from allowances. An entity must hold a permit to emit but it is the allowances that must be delivered in order to offset emissions.

63. Statutory schemes differ from voluntary schemes in at least two respects: (1) statutory schemes are imposed by the government so that participation in the scheme is mandatory and (2) in statutory schemes, the amount of free emissions allowances is not negotiated with the scheme administrator. Instead, the scheme administrator unilaterally determines (a) the scope of the scheme and (b) the amount of free allowances to be issued to permit holders.

64. Because of the schemes' overlapping characteristics, staff think the discussion of voluntary schemes to be helpful in structuring the discussion of statutory schemes. However, this does not imply that any conclusions for voluntary schemes are applicable to statutory schemes by default. Instead, the discussion of voluntary schemes could be used as a starting point, taking into consideration the differences between the schemes.

Appendix: Numerical example

65. The following example is for illustration purposes *only*. It illustrates the interactions between the linked items that result from participation in a voluntary scheme. The example is not meant to prejudge any decisions of the boards about (a) recognition (b) measurement or (c) presentation of the elements in a voluntary emissions trading scheme.

66. Consider the example used throughout the paper on 1 January 2010 and assume that the scheme expires after the compliance year 2010. That means an entity holds a membership right for the 2010 compliance year and 100 allowances for the 2010 compliance year. The entity has not yet emitted in the compliance year 2010 on 1 January 2010 and estimates that it will, at the end of the compliance year, pay 110 allowances to settle the promise to pay allowances for the 2010 compliance year. The market price per allowance is USD 10 as of 1 January 2010.

67. The example employs the following assumptions on 1 January 2010:

    (a) Allowances are initially recognised at the market price of allowances (ie USD 1,000).

    (b) The estimated amount that is required to settle the promise at the end of the compliance year 2010 is measured by reference to the market price of allowances (ie USD 1,100).

    (c) The entity believes it will get a value of USD 100 from the membership in the scheme. (The entity must expect to get at least this much in economic returns; otherwise, it would not have participated in the scheme.)

68. The following diagram illustrates the different elements in the scheme on 1 January 2010. The dotted lines indicate that there are different views on whether the promise to pay allowances creates a liability on 1 January 2010. If the IAS 37 / Statement No. 143 approach (View 1) is applied assets of USD 1,100 are recognised on 1 January 2010 but no liability. This is because,

according to View 1, the entity does not have a liability on 1 January 2010 because it has not yet emitted at that date. If the IFRS 3 / Statement No. 141(R)(R) approach (View 2) is applied assets of USD 1,100 are recognised on 1 January 2010 and a liability. The liability reflects the estimated amount that is required to settle the promise at the end of the 2010 compliance year (ie USD 1,100).

69.