Staff Paper

Project	Emissions Trading Schemes
Topic	Existence and recognition of liabilities for the allocation in a cap and trade scheme

Purpose

1. The purpose of this paper is to provide analysis of the existence and recognition of a liability when an entity receives an allocation of allowances from the scheme administrator for no monetary consideration (the 'liability for the allocation'). This paper examines whether a liability exists and what the nature of the present obligation is.

2. The analysis in this paper is applicable to both voluntary and statutory cap and trade schemes.

3. The staff conclude that a liability exists when an entity is allocated allowances. The staff also recommend that this liability be recognised at the time of the allocation of allowances as the 'liability for the allocation'. However there is a disagreement among the staff as to what the present obligation is (paragraphs 56-59). Some believe the present obligation is an obligation to refrain from emitting to keep the allowances (View 1(a)) and some believe that the present obligation is an obligation to comply with the scheme requirements specifically to refrain from emitting to be able to keep the allowances or to return the allowances (View 1(c)).

4. This paper does not discuss the following issues that will be addressed at future board meetings:

   i. the measurement of the liability for the allocation of allowances;

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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.

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ii. the interaction of the entity's emissions with the liability for the allocation;

iii. the presentation issue of netting;

iv. whether, and when, a right to future allocations constitutes an asset; and

v. presentation and disclosure issues (other than netting).

AP 10C/6C provides a basic description of these issues and some of the alternatives under consideration.

Board decisions

5. At the March 2009 meeting[1], the IASB tentatively decided that if an entity is allocated allowances (for no monetary consideration), the entity incurs an obligation to reduce its emissions below the level represented by those allowances (ie its cap). Only if the entity fulfils this obligation will it be entitled to retain any of the allowances. The Board tentatively decided that the entity should recognise a liability for this obligation. However, there were various views about the rationale for recognising such a liability and about the nature of the present obligation[2]. The FASB discussed these issues at its April 2009 meeting, but made no decisions.

6. At their November 2009 joint meeting, the FASB and the IASB discussed the accounting for the allocation of allowances (for no monetary consideration) in a cap and trade scheme with voluntary participation. The meeting focused on whether, and when, participation in a voluntary scheme creates a liability. The staff did not ask the boards to make any decisions at this meeting, but they did seek advice from the boards as to what creates the obligating event in a voluntary scheme. Both boards indicated a preference for a view that an entity can have an obligation before it emits. The boards also indicated at this meeting that they did not distinguish between voluntary and statutory schemes.

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[1] At the March 2009 meeting the IASB also tentatively decided that an entity should recognise allocated allowances (in a cap and trade scheme) as assets and initially measure them at fair value.

[2] At the March 2009 meeting the IASB also tentatively decided that the liability is measured initially at the fair value of the allowances.

Is there a liability when the allowances are allocated?

7. Entities that participate in statutory and voluntary cap and trade schemes *may* receive an allocation of allowances[3] from the scheme administrator for no monetary consideration.

8. There are two views on whether a liability for the allocation of allowances exists and whether it should be recognised. One view is that the allocation of allowances creates a present obligation and there is a liability for the allocation. The alternative view is that there is *no* present obligation and thus *no* liability when the allowances are allocated.

9. Because a present obligation is an essential characteristic of a liability, a further issue is the nature of the present obligation. Board members who support the view that there is a liability for the allocation have provided different rationales for the nature of the present obligation when allowances are allocated.

10. Two of the rationales discussed previously are that the present obligation is an obligation to refrain from emitting to be able to keep the allowances, and an obligation to return the allowances.

11. The analysis in this paper proceeds as follows:

View 1: The allocation of allowances creates a present obligation and there is a liability for the allocation. This present obligation is either:

(a) an obligation to refrain from emitting to be able to keep the allowances; or

(b) an obligation to return the allowances; or

(c) an obligation to comply with the scheme requirements; specifically to refrain from emitting to be able to keep the allowances or to return the allowances.

[3] The volume of these allocations is expected to decrease over time.

View 2: The items identified in View 1 are *not* present obligations when allowances are allocated. Thus *no* liability exists when the allowances are allocated. An entity has a liability only when it emits.

Staff analysis

View 1: *The allocation creates a present obligation and there is a liability for the allocation*

12. According to View 1, an entity incurs a liability when the allowances are allocated (the 'liability for the allocation') because the definitions of a liability in the boards' frameworks are met.

13. 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]

14. 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]

15. It is clear from the definitions that a present obligation is an essential characteristic of a liability in both frameworks. Consequently, for a liability to exist in View 1, (when the allowances are allocated), there must be a present obligation that has resulted from past events.

16. A present obligation is a duty or obligation to act in a certain way[4]. A present obligation must also be unconditional, in that it is unavoidable[5] and exists independently of future events[6].

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[4] The IASB *Framework* indicates that 'an obligation is a duty or responsibility to act or perform in a certain way' (Paragraph 60).

[5] The IASB *Framework* indicates that a present obligation must leave an entity with 'little, if any discretion to avoid the outflow of resources to another party' (paragraph 61). A similar concept exists in paragraph 36 of FASB *Concept Statement 6*.

[6] Paragraph 18 of the 19 February 2010 working draft of IFRS XX *Liabilities* indicates that a present obligation is unconditional when it is independent of future events. This concept also exists in Paragraph 19 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

17. When an entity becomes subject to an emissions trading scheme, it has a duty or obligation to comply with the law. Statutes and laws by themselves, however,[7] do not unconditionally create obligations that are independent of future events. To become unconditionally obliged, an entity must either conduct the activity to which the law applies (which in this case is emitting, which would be View 2) or accept a duty to others to conduct the activities to which the law applies[8] (ie through an agreement).

18. When the allowances are allocated, the scheme administrator does not impose any additional requirements on an entity, other than those specified under the scheme. However, the lack of monetary consideration provided by the entity when the allowances are allocated brings into question whether the scheme administrator retains any rights over the allocated allowances, and whether the entity has any obligations related to the allocated allowances. To determine what the rights and obligations may be requires an examination of the terms of the scheme.

19. The staff took different approaches when examining the terms of the scheme and the rights and obligations when the allowances are allocated. These different approaches have resulted in the different views on what the present obligation is (View 1(a), (b) and (c) below).

20. Although the staff have different views on the nature of the present obligation, the staff agree that a liability comes into existence at the time of the allocation. Specifically because when an entity is allocated allowances, it can no longer avoid doing *something* under the scheme. Furthermore, when the entity receives the allocation it accepts a duty to comply. Thus the obligating event for the liability for the allocation, in all views, is the allocation of allowances.

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[7] Paragraph 22 of IASB Agenda Paper 8B, April 2009 (http://www.ifrs.org/NR/rdonlyres/6EB4A6A5-55B9-4AB1-A8DE-53B757078904/0/IAS370904b08Bobs.pdf). This is also consistent with the boards' conclusion on the elements portion of the conceptual framework (http://www.fasb.org/project/cf_phase-b.shtml).

[8] Paragraph 22 of IASB Agenda Paper 8B, April 2009 (http://www.ifrs.org/NR/rdonlyres/6EB4A6A5-55B9-4AB1-A8DE-53B757078904/0/IAS370904b08Bobs.pdf).

What is the nature of the present obligation in View 1?

21. An essential characteristic of a liability is a present obligation. For the liability for the allocation, there are 3 different views on the nature of the present obligation when the allowances are allocated. The 3 views differ on what the present obligation is:

    i) View 1(a) – an obligation to refrain from emitting to keep the allowances;

    ii) View 1(b) – an obligation to return the allowances (if the entity emits); or

    iii) View 1(c) – an obligation to comply with the scheme requirements; to refrain from emitting to keep the allowances or to return the allowances.

View 1(a) – obligation to refrain from emitting to keep the allowances

22. According to View 1(a), when the allowances are allocated for no monetary consideration, the entity needs to do *something* to keep (or maintain a right to use) the allocated allowances beyond the compliance period. This *something* is an obligation to refrain from emitting. This obligation becomes unavoidable when the allowances are allocated for no monetary consideration, because the entity then has no choice but to comply with the obligation. When an entity receives an allocation of allowance, the entity accepts a duty to comply with the rights and obligations.

23. We discussed above that to be a present obligation, the obligation must be unconditional, in that it cannot be avoided and it must exist independently of future events. It is helpful when analysing the nature of the present obligation to consider how it exists independently of future events. In View 1(a), it might be difficult to see how the obligation to refrain from emitting exists independently of future events, because the entity's future action (emitting or not emitting) will determine whether the obligation is met.

24. Under this view, an unconditional obligation to refrain from emitting arises from the allocation of the allowances, which is a past event. The entity is bound

by the obligation regardless of whether it emits in the future. It is only the measurement of the obligation that will be determined by the entity's future actions. Uncertainty related to the measurement or outcome of the obligation does not preclude us from concluding that the obligation exists independently of future events. Thus the obligation to refrain from emitting is unconditional and exists independently of future events.

25. The obligation to refrain from emitting to keep the allowances in View 1(a) can be compared to the obligations that exist when an entity receives a grant with conditions. If the recipient of the grant does not meet the conditions, the recipient will be penalised and will be required to return the grant. An example of this type of conditional grant would be a farmer who receives a grant from the government that he may keep if the farmer does not plant a particular crop for a specified period. If the farmer plants that crop within the specified period, the farmer would be required to repay the grant. Even though the farmer's actions will determine the measurement of the obligation, an obligation exists when the farmer receives the grant. This obligation is treated as a present obligation and a liability under IAS 41 *Agriculture* and Accounting Standards Codification Topic 958 *Not-for-Profit Entities* ie a liability[9] or a 'refundable advance' should be recognised until the conditions of the grant (or the transfer of assets) are met (or substantially met[10]). IAS 41 and Topic 958 also indicate that conditional grants should not be recognised in income until the attached conditions are met[11].

26. The obligation to refrain from emitting in View 1(a) can be compared to the obligation in a non-compete agreement, because a non-compete agreement also creates an obligation not to do something in the future. An entity that is subject

[9] Paragraph B72 of IAS 41 indicates that 'a liability should be recognised under the *Framework* rather than income since an entity has a present obligation to satisfy the condition arising from past events'.
[10] Paragraph 958-605-25-13 of Topic 958 indicates that 'A transfer of assets with a conditional promise to contribute them shall be accounted for as a refundable advance until the conditions have been substantially met'.
[11] Paragraph 35 of IAS 41 indicates that 'an entity shall recognise the government grant in profit or loss when, and only when, the condition attaching to the government grant are met'.

to a non-compete agreement may be required to pay a penalty, or return the amount initially paid, if the non-compete agreement is breached.

27. However, there is no specific guidance in IFRSs or US GAAP on accounting for non-compete agreements. In fact, there are two views on whether a non-compete agreement creates a present obligation and thus a liability.

28. The staff believe that there are differences between a non-compete agreement and the obligation to refrain from emitting, including the fact that the scheme administrator does not receive a direct economic benefit from the restrictions placed upon the entity by the scheme. In the staff's view, this difference may enable the boards to conclude that there is a present obligation and thus a liability when the allowances are allocated.

29. Opponents of this view argue that the 'obligation' to refrain from emitting can be avoided, by emitting and returning allowances. Thus opponents conclude that the 'obligation' to refrain from emitting cannot be a present obligation on its own.

30. Furthermore, opponents also disagree with the conclusion that the 'obligation' to refrain from emitting exist independently of future events. These opponents believe the outcome is within the control of the entity. Thus, they disagree with the conclusion that the 'obligation' to refrain from emitting is a liability.

View 1 (b) – obligation to return the allowances;

31. Under View 1(b), when the allowances are allocated for no monetary consideration, the scheme gives the scheme administrator a right to require the return of the allowances when an entity emits. The scheme administrator will exercise this right to require return if the entity emits. This right to require return yields an obligation of the entity to return the allowances, if it emits.

32. These rights and obligations become unavoidable when the allowances are allocated for no monetary consideration, because the entity then has no choice but to comply with those rights and obligations. On receipt of the allowances, the entity has accepted an obligation to return allowances contingent upon emitting.

33. To determine if the obligation to return the allowances if the entity emits, is a present obligation, the obligation must be unconditional, in that it cannot be avoided and must exist independently of future events (see paragraph 16 above).

34. In View 1(b), it appears more difficult to see how the obligation to return allowances exists independently of future events, because the entity will return allowances only if it emits.

35. The unconditional obligation to return allowances, in View 1(b), arises from the allocation of the allowances, which is a past event. The entity is bound by the obligation even if it doesn't emit in the future. It is only the measurement of the obligation that will be determined by the entity's future actions. Although the quantum of resources required to settle the obligation will be determined based upon an entity's future actions that are within its control, the obligation is created on allocation of the allowances. Uncertainty related to the measurement or outcome of the obligation does not preclude us from concluding that the obligation exists independently of future events. Thus the obligation to return allowances is unconditional and exists independently of future events.

36. To provide more context for this obligation, it is helpful to compare the obligation in View 1(b) to a call option. The buyer of the option (the scheme administrator) provides consideration (in the form of an allocation) for a right (ie the right to require the return of allowances) that it may choose to exercise if specified events occur (ie if the writer (the entity) emits)[12]. At the time of entering into the contract, the writer (the entity) becomes unconditionally obligated to satisfy the buyer's right (ie obligated to return the allowances) that the buyer may choose to exercise. This unconditional obligation exists at the time of entering into the contract, even though the measurement of the writer's

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[12] Some criticise the comparison to a call option, because the buyer of a call option typically has a choice to exercise its right, whereas in emissions trading schemes, the scheme administrator appears to have no choice in deciding to exercise its right to require the return of allowances when an entity emits. Others may rebut this view and argue that the scheme administrator will always have a right to decide whether to enforce the law that it administers. The comparison to a call option is, however, meant to illustrate that obligations may exist for the writer, even when the outcome is within the control of the option writer (the entity).

obligation is dependent upon future events, some of which may be within the writer's control. (For example, the buyer may only exercise its right after the writer completes a public offering or reaches a certain profit level, etc.)

37. Opponents of this view argue that the 'obligation' to return allowances can be avoided[13], by refraining from emitting. Thus opponents conclude that the 'obligation' to return allowances cannot be a present obligation on its own.

38. Opponents also disagree with the conclusion that the 'obligation' to return allowances exist independently of future events. These opponents believe the outcome is within the control of the entity. Thus, they disagree with the conclusion that the 'obligation' to return allowances is a liability.

View 1(c) – obligation to comply with the scheme requirements; to refrain from emitting to keep the allowances or to return the allowances

39. When the allowances are allocated, the scheme administrator does not impose any additional requirements on an entity, other than those specified under the scheme. Therefore to determine an entity's obligations when the allowances are allocated, we must review the terms of the scheme. The terms of the scheme require the entity to return the allocated allowances, if the entity emits or to refrain from emitting to keep the allocated allowances.

40. These requirements become unavoidable when the allowances are allocated for no monetary consideration, because the entity then has no choice but to comply with those requirements of the scheme. By receiving the allocated allowances, the entity accepts a duty to comply with those requirements[14]. Thus, when the allowances are allocated, the obligation to comply with those scheme requirements is unconditional.

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[13] This may not be true for entities that cease operations if they are subject to schemes that have closure rules, specifically a clawback provision. This is discussed in Appendix B.

[14] Some believe that when an entity receives allowances for no monetary consideration, the entity enters into a form of agreement. Effectively the entity agrees to reduce its emissions below the level of allowances received, or to return allowances for each unit of emission. This concept was presented to the IASB in agenda paper 13B in the March 2009 meeting. It was also presented to the FASB as memorandum 3b at the April 2009 meeting. This is discussed further below.

41. No such duty exists for purchased allowances. This issue is further discussed in Appendix A.

42. Therefore, when an entity receives an allocation of allowances for no monetary consideration, it is unconditionally obligated to comply with the scheme requirements; to refrain from emitting to keep the allowances or to return them, if it does not emit.

43. Importantly, after an entity receives allocated allowances, the entity cannot avoid the obligation to comply with those scheme requirements through its future actions. Regardless of its actions (emitting or not emitting), the obligation to comply with those scheme requirements will require the entity to transfer or use resources: the entity must either transfer resources by surrendering allowances or use resources to reduce emissions[15]. Future events will determine which resources the entity will transfer, and may determine the measurement of the obligation, however the obligation exists independently of these future events.

44. The staff conclude that the obligation to comply with the scheme requirements is a present obligation, in that it is unconditional, it cannot be avoided and it exists independently of future events (see paragraph 16 above).

45. Some may wish to characterise the present obligation to comply with the scheme requirements as a stand-ready obligation. In particular because it appears that the obligation to comply with the scheme is an unconditional obligation whose outcome is conditional upon future events (refraining or emitting). However in this case, the method of the settlement of the obligation may be variable (ie refraining or returning), but the obligation is unconditional as the entity must comply with the scheme. The obligation to comply with the scheme requirements therefore appears to be more akin to a loan that provides the borrower with the option to settle the liability with either cash, another asset

[15] Topic 410-20-55-4 *Asset retirement obligations* indicates that an obligating event 'leaves [an entity] little or no discretion to avoid the future transfer or use of assets'.

or by providing services. The loan is not a stand-ready obligation, it is simply an obligation to pay, with an option of settling it in different ways.

46. Opponents of this view do not believe that there can be a single obligation for two separate requirements of the scheme that have different methods of settlement. Furthermore, they do not believe that refraining from emitting or returning allowances are requirements of the scheme. They believe that there are two separate obligations that are described in View 1(a) and View 1(b) above.

Definition of a liability

47. Although there are different views for the nature of the present obligation, we have concluded that a present obligation exists when the allowances are allocated (a past event). In order to conclude that the definition of a liability is met, we must also determine that there will be an outflow of resources or a transfer of assets to settle the obligation. It is clear that a transfer of assets (the allowances), by way of returning them, is one way by which the entity can settle the obligation. In addition, in order to refrain from emitting, an entity will incur costs to implement methods to reduce its emission, or it will restrict its activities. Both of these are outflows of resources.

48. The definition of a liability is therefore met in View 1: there is a past event, an outflow of resources and a present obligation. (The analysis of the criteria of recognition as applied to this liability is discussed below.)

View 2 *– There is no present obligation and thus no liability when the allowances are allocated. An entity has a liability only when it emits.*

49. According to View 2, the obligation to comply with the scheme requirements, the obligation to refrain from emitting (to keep the allowances) and the obligation to return allowances are not present obligations when allowances are allocated. According to View 2, an entity has *no* present obligations when it receives an allocation of allowances. Consequently, no liability exists when the allowances are allocated.

50. An entity has a liability when it emits. According to View 2, when an entity emits, the obligation to surrender allowances to the scheme administrator becomes unavoidable, and thus a present obligation exists and the definition of a liability in the boards' frameworks is met. For View 2, a liability will be recognised for the obligation to return allowances when the entity emits.

51. Importantly, View 2 does not result in recognising a liability when the allowances are allocated. As a result, if the allocated allowances are initially measured at any amount other than NIL[16], this view will require the credit side of the entry to be recognised in the income statement as a gain[17]. This is colloquially referred to as a 'Day 1 gain'.

52. By recognising a 'Day 1 gain', View 2 represents the allocation of allowances as a benefit (or a windfall) at the time the entity receives the allocation. This benefit results from receiving an allowance that can easily be converted into cash.

Pros and Cons of View 1 and View 2

53. By identifying a liability at the time of allocation, View 1 attempts to capture the fact that the entity does not have an unfettered right to keep the allocated allowances. In fact, the entity has an obligation to return them, if the entity emits. Proponents of View 1 believe that this view most faithfully represents the economic realities faced by entities that receive allocated allowances. Furthermore, proponents of View 1 believe that recognising a gain upon receipt of the allocated allowances (as in View 2), is misleading to investors. This is because the entity is actually worse off, not better off, having become subject to the scheme.

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[16] Measurement of the allowances and of other components of the scheme will be discussed at a future board meeting.

[17] There is some variation in practice for recognising this gain. Some preparers recognise the gain on the income statement, but some also defer the gain in accordance with IFRIC 3 *Emission Rights* (withdrawn) and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. The staff realise that there may be an alternative method of presentation for the gain, which is to present it in other comprehensive income. If the boards select View 2 and it is considered necessary, the staff will include this issue in the discussion of presentation at a future board meeting.

54. Those who support View 2 believe that this view faithfully represents that entities receiving allocated allowances are 'better off' than other scheme participants that have not received allowances. Furthermore, supporters believe that the allocated allowances constitute a resource for the entity with no associated obligations. For these reasons, proponents of View 2 believe that recognising a gain on receiving the allocated allowances is the most appropriate accounting.

55. Those who oppose View 1 do not believe that the allocation of allowances for no monetary consideration creates a present obligation. On this basis, the opponents believe that View 1 (regardless of how the present obligation is characterised) is misleading, because it misrepresents entities' liabilities under the scheme.

Staff recommendation

56. The staff recommend that a liability results from the allocation of the allowances (View 1). However the staff disagree on what the present obligation is. Some staff prefer View 1(a) and other staff prefer View 1(c).

57. The staff that prefer View 1(a) believe that upon allocation of the allowances the entity has an unconditional obligation to refrain from emitting in order to keep the allowances. Those staff members do not support View 1(c) as they do not believe that refraining from emitting or returning the allowances are requirements of the scheme. The scheme administrator may retain a right if the entity emits or if the entity wants to keep the allowances it is obligated to refrain from emitting but the scheme itself does not impose requirements. Therefore they do not believe that the obligation that meets the definition of a liability is the obligation to comply with the scheme requirements as that view purports. The scheme could, however, cause an entity to have a liability once certain provisions are met or not met. It is no different than if a traffic law exists that has provisions requiring the payment of $100 if caught speeding. The speeder does not have an obligation to comply with the requirements of the law if caught speeding but does have an obligation to pay $100 if caught speeding.

The staff that do not support View 1(c) think that View 1(c) inappropriately characterizes what the obligation is as well as how it is created.

58. The staff that prefer View 1(c) believe that when an entity is allocated allowances, the entity, in effect, accepts a duty to comply with the scheme and thus becomes unconditionally obliged to comply with the scheme requirements; to refrain from emitting to keep the allowances or to return them, if it emits. The obligating event of the allocation of allowances leaves the entity with no choice but to comply with the requirements of the scheme; to refrain or to return. Furthermore, the staff that prefer View 1(c) believe that an entity's obligations at the time of receiving the allocation can only be determined by considering the scheme itself, its principles, provisions and requirements.

59. The staff that prefer View 1(c) rejected View 1(a) and View 1(b). They do not support the conclusion that refraining from emitting or returning allowances are present obligations on their own. This is because an entity can avoid the scheme requirement of refraining from emitting by returning allowances, and conversely, avoid the requirement to return allowances by refraining from emitting (see also paragraphs 29 and 37 above). Together, these scheme requirements cannot be avoided when the allowances are allocated. Thus, when the allowances are allocated, the entity has a present obligation to comply with the scheme requirements; to refrain from emitting to keep the allowances or to return them, if it emits.

Does the liability for the allocation of allowances meet the recognition criteria?

60. Before we can conclude that a liability can be recognised, we must consider the recognition criteria in both frameworks. The two criteria that are included in both frameworks are that an item meets the element definition and that it is reliably measurable. The staff have concluded above that the definition of a liability is met. Although specific measurement issues will be addressed in a separate paper, it appears reasonable that an entity may be able to use the market price of allowances to measure reliably the amount that it would rationally pay to be relieved of the obligation.

61. As discussed in AP 10A/6A, there are two recognition criteria in the boards' frameworks that are not congruent with each other. The staff believe that this is not due to fundamental differences. These are the criterion of probable future economic benefits flowing from the entity in the IASB *Framework* and the criterion of relevance in the FASB *Concepts Statement 5*.

62. Based upon the analysis above, the criterion of probable future economic benefits flowing from the entity is met. Specifically, the liability for the allocation of allowances will result in an outflow of resources when the entity either returns allowances or restricts its activities in order to refrain from emitting.

63. In addition, the criterion of relevance is also met. The staff believe (and have anecdotally heard) that the recognition of a liability (and the measurement of that liability) at the time that the allocation is received may influence users' decisions. This is because users want to be able to distinguish between entities that expect to be able to refrain from emitting, and so may be able to keep the allocated allowances, from entities that may not refrain from emitting and thus will return allowances. This information may help users better understand the affect of the scheme on an entity, and possibly how it may affect them in the future.

64. The staff conclude that the liability for the allocation of allowances in all views would meet the criteria for recognition in the boards' frameworks.

Staff recommendation

65. This liability is recognised as a liability for the allocation.

Questions for the boards:

1. Do the boards agree with the staff recommendation that there is a liability for the allocation of allowances? If so, which view on the nature of the present obligation do you support?

    i. View 1(a) – obligation to refrain from emitting to keep the allowances;

    ii. View 1 (b) – obligation to return the allowances; or

    iii. View 1(c) – obligation to comply with the scheme requirements; to refrain from emitting to keep the allowances or to return the allowances.

2. Do the boards agree that the liability for the allocation of allowances meets the recognition criteria?

If the boards support View 2, please answer the following additional question:

3. View 2 will yield income ('Day 1 gain') when an entity receives an allocation of allowances. Do you agree with the staff's rationale that supports View 2?

Appendix A

Present obligations for purchased allowances

A1. The staff recommend that an entity has a present obligation when it is allocated allowances (the obligating event). The relevant question is whether an entity also has a *present* obligation when it purchases allowances?

A2. An entity does not have a present obligation when it purchases allowances because:

(a) the seller does not retain any rights over purchased allowances;

(b) any liabilities that may be incurred at the time of purchase are *different* from the liability when an entity is allocated allowances;

(c) the liability for the allocation is linked to the allocation of allowances; and

(d) the event of emitting is a separate obligating event.

A3. When an entity purchases allowances, all of the rights and obligations are specified at the time of exchange. The seller does not retain any rights over the purchased allowance, as the seller receives cash or a promise to pay in return for giving up its rights to the allowance. The purchaser therefore receives an unfettered right to the purchased allowance. This is the also the case when the scheme administrator is the seller. In this case, the scheme administrator also gives up its rights to the allowances upon completion of the sale transaction.

A4. The consideration provided by the purchaser of allowances may include a promise to pay cash in the future. This promise to pay cash in the future (ie an account payable) is a liability (to pay), but it is *different* from the liability for the allocation.

A5. The liability to pay arises from the purchase of allowances. However, the liability for the allocation arises from the allocation. Specifically, the liability for the allocation arises from the terms of the scheme that the entity agrees to comply with when it receives the allocation of allowances. The allocation of allowances and the liability for the allocation are linked.

A6. Importantly, the purchaser does not have a present obligation *as a result of purchasing the allowance*. Although allowances are designed specifically for satisfaction of obligations, the event of purchasing an allowance is *not an obligating event*. When an entity purchases allowances, the scheme administrator cannot *require* an entity to do anything within the scheme. This point is clear if the purchaser is not a participant in the scheme (ie the purchaser is a broker or another independent party). This point may be less clear if the purchaser is an entity who participates in the scheme, particularly if the seller is the scheme administrator. However the fact that those who are not subject to the scheme can also purchase allowances illustrates that a purchaser is not bound by the scheme as a result of its purchase.

A7. Since the purchase of allowances is not the obligating event, when is an entity presently obliged to return allowances?

A8. The obligating event for the return of allowances is the event of emitting. When an entity has only purchased allowances, after it emits the entity can no longer avoid returning allowances.

A9. When an entity has received an allocation of allowances and it emits, the event of emitting may influence measurement of the liability. Some may argue that by emitting, the nature of the present obligation changes. The issues of measurement and the interaction of an entity's emission with the liability for the allocation are outlined in AP 10C/6C and will be discussed further at a future board meeting.

A10. Therefore the staff conclude that at the time of purchasing an allowance, an entity is not presently obliged under the scheme requirements.

Appendix B

Closure rules and clawback provisions

B1. Some statutory emissions trading schemes include specific provisions for allocated allowances when an entity ceases, or effectively ceases, operations. In many cases, an entity that ceases operations after receiving an allocation of allowances will be permitted to keep its allocation of allowances (because it has refrained from emitting), but it will not be eligible for future allocations. For these entities, the other scheme requirements remain the same. Consequently, the scheme will also require these entities either to refrain from emitting (to be able to keep the allowances) or to return the allowances. Because these entities are ceasing operations (refraining from emitting), these entities will be able to keep the allocated allowances.

B2. Other emissions trading schemes include a mechanism requiring an entity to return previously-allocated allowances to the scheme administrator if the entity ceases (or effectively ceases) operations. This is a 'clawback' provision.

B3. A participant in an emissions trading scheme with a clawback provision is obliged by the scheme to return previously-allocated allowances if it emits OR if it refrains from emitting by ceasing operations. Consequently, if an entity ceases operations, it cannot entity will not be able to keep the allowances. These entities who cease operations will therefore *only* be obliged to return allowances.

B4. Entities that are subject to a scheme that includes a clawback provision, but do not yet cease operations, will be able to refrain from emitting and so to keep their allowances.

B5. The staff believe that even though entities ceasing operations in a scheme with a clawback provision cannot keep the allowances, these entities will also become obliged to comply with the scheme requirements when the allowances are allocated. Consequently the staff recommendation will also apply to these entities.