STAFF PAPER

1—2 October 2015

Accounting Standards Advisory Forum

Project	**Pollutant Pricing Mechanisms (formerly Emissions Trading Schemes)**		
Paper topic	Cap-and-trade emissions trading scheme liabilities		
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Introduction

1. In July 2015, ASAF members considered a simple numerical example of a typical cap-and-trade type of emissions trading scheme (ETS). The example outlined some common approaches used to account for such schemes in practice. It showed how different accounting approaches produce different results in the statements of financial position and profit and loss and other comprehensive income.

2. The agenda papers discussed at the July 2015 ASAF meeting, together with a summary note of the meeting, are available on the IFRS website.[1] An extract of the meeting summary relating to the pollutant pricing mechanisms discussion is reproduced in Appendix 1 of this paper. The following points from that summary have been taken into account in developing the example that is the focus of this paper:

   (a) Most members think that recognising a ‘day 1 gain’ in profit or loss would not faithfully represent the economics of the scheme [to avoid the recognition of a day 1 gain, a ‘day 1 credit balance’ could instead be recognised in the statement of financial position];

[1] The July 2015 ASAF agenda papers and meeting summary are available at http://www.ifrs.org/About-us/IASB/Advisory-bodies/ASAF/Pages/ASAF-meetings.aspx.

(b) When there is a fully effective hedge between the quantity of pollutants emitted and the allowances allocated free-of-charge by the government, many members preferred to reflect the effective hedge by using an approach that would result in no gain or loss being recognised during the compliance year;

(c) To provide relevant and transparent information to users of financial statements, many ASAF members support an approach that:

(i) measures the allowances, both initially and subsequently, at fair value through profit or loss; and

(ii) measures at fair value through profit or loss the liability to remit allowances to the government equal to the volume of pollutants emitted.

3. In this meeting, we are not seeking to address all issues related to the possible model being explored at this time. In outlining the possible model in this paper, we have made some simplifying assumptions and omitted discussion of some issues. This is intended to help focus on two particular issues for which we are seeking advice from ASAF members:

(a) The classification and subsequent accounting treatment of the 'day 1 credit balance' (paragraph 2(a)); and

(b) The timing of recognition of the liability to remit allowances to the government for the pollutants emitted (paragraph 2(c)(ii)).

4. The purpose of this session is to stimulate debate. We acknowledge that member's views on the issues may change after the meeting. We also acknowledge that views may change as a result of discussing other related issues at a later date. Questions for ASAF members are set out in paragraph 47.

Background

5. Emissions trading schemes (ETS) are a regulatory approach to reduce emissions of specified pollutants over time by imposing costs on excess emissions, through market based mechanisms rather than through direct fees or penalties. Cap-and-trade ETS are designed to put a price on what was previously considered a freely

available ‘public good’; that is, clean air. Prior to the introduction of the scheme, entities could emit unspecified quantities of pollutants into the air without any monetary value being attached to the emissions.

6. There seems little disagreement with the view that, once an entity has emitted the specified pollutants, it has an obligation to remit allowances to the government, equal in quantity to the volume of pollutants emitted. If a participant in a cap-and-trade ETS does not receive allowances allocated free-of-charge by the government, measuring this liability at current value is generally considered to be consistent with the measurement requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

7. However, when introducing a cap-and-trade ETS, many governments recognise that imposing a new cost on what was previously a free activity could be economically damaging, not merely for the individual entities that are subject to the schemes but for a country’s economy as a whole. As a result, many governments have chosen initially to allocate allowances to participants in the scheme free-of-charge.

8. Some schemes include, or have plans to include, a system for auctioning some allowances, instead of allocating all allowances free-of-charge. For the purpose of this paper, we have focussed on a scheme that has no auction system in place and allocates all of the allowances free-of-charge to participants. We will consider the implications of an auction system at a later date.

9. The free-of-charge allocations are made only to participants in the scheme. The total number of allowances allocated is equal to the overall emissions cap imposed by the government. The quantity of allowances allocated to each participant is based on a number of factors, including the quantity of each participant’s historical emissions and expected future emissions. Allocations are designed to incentivise participants to find the most cost-effective way of achieving the emissions reductions that are imposed by the scheme.

10. The allocation of free-of-charge allowances is intended to ease the cost of the transition to the ETS. Because the schemes are designed to incentivise participants to reduce emissions, the overall number of allowances available under the cap decreases over time. As a result, the number of allowances allocated to

each participant is also expected to decrease over time. Consequently, the scheme is expected to impose a cost on the participants that will increase over time, unless the entity takes action to reduce its level of emissions.

11. It is the accounting treatment of these allocated allowances that has caused the greatest difficulties in developing an accounting model for cap-and-trade ETS. The issues include:

    (a) Should the allowances received free-of-charge be recognised as assets?

    (b) How should allocated allowances be measured, both initially and subsequently?

    (c) Should a day 1 credit balance, equal in value to the allocated allowances, be recognised as a liability when the allocated allowances are recognised?

    (d) How should this liability be measured, both initially and subsequently?

12. As noted in paragraph 2, the preferences of many ASAF members suggest that we should explore an accounting model that:

    (a) recognises the allocated allowances as assets and measures them at fair value, both initially and subsequently;

    (b) does not recognise a day 1 gain when the allocated allowances are received; and

    (c) does not recognise a gain or loss during the compliance year when the quantity of allocated allowances provides a fully effective hedge against the quantity of pollutants emitted.

13. In order to develop an accounting model that would achieve the three aspects set out in paragraph 12:

    (a) a ‘day 1 credit balance’ would need to be recognised in the statement of financial position, measured initially at the same value as the allocated allowances received; and

    (b) the ‘day 1 credit balance’ would need to be remeasured subsequently, on the same basis as the allocated allowances that provide the effective hedge.

14. The remainder of this paper focuses on such a model. In particular, it focuses on

    (a) the classification and subsequent accounting treatment of the 'day 1 credit balance' (paragraphs 16-35); and

    (b) the timing of recognition of the liability to remit allowances to the government equal to the volume of pollutants to be emitted (paragraphs 38-45).

15. In this paper, we do not discuss whether the amounts calculated should be presented on a gross or net basis in the financial statements. At this time, we would like to focus on the two specific issues identified in paragraph 14. Presentation and disclosure issues will be considered at a later date.

Day 1 credit balance—is it a liability?

16. In practice, when an entity recognises, and initially measures at fair value, allocated allowances received free-of-charge from the government, the entity recognises a day 1 credit balance. This balance is measured at the same amount and is typically described as a government grant. The amount is then accounted for in accordance with IAS 20 *Accounting for Government Gants and Disclosure of Government Assistance*.

17. As a result, the government grant is, in effect, treated as deferred income. This means that the amount initially recognised in the statement of financial position is, over time, amortised on a systematic basis and recognised as income in profit or loss.

18. At the same time, the entity will recognise an expense in profit or loss as it emits the specified pollutants, creating an obligation to remit allowances to the government, equal in quantity to the volume of pollutants emitted. This obligation is reflected in the statement of financial position as a provision.

19. Throughout the compliance period, the entity will recognise both income (the amortisation of the government grant) and an expense (the creation of the emissions provision).

20. Some commentators suggest that this classification and treatment as a government grant is inappropriate. This is on the grounds that:

(a) the granted allowances should not be treated as income because they are expected to be repaid to the government, unless the entity takes action to reduce its emissions below the quantity of allocated allowances received; and

(b) the day 1 credit balance does not meet the definition of a liability contained in the *Conceptual Framework*.

21. However, many of the same commentators do not think that it is appropriate to recognise a day 1 gain when the allocated allowances are received. Instead, they suggest that an alternative classification needs to be found, which can be supported more clearly by the *Conceptual Framework*.

Definition of a liability in the Conceptual Framework

22. In the existing *Conceptual Framework*, a liability is defined as:

> 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.[2]

23. Many who suggest that the day 1 credit balance does not satisfy this definition focus on the entity's obligation to remit the allowances to the government at the end of the compliance period, based on the quantity of pollutants emitted during that period. Consequently, many suggest that the entity does not have a present obligation to remit the allowances, but instead will incur such an obligation in the future when it produces emissions. That is not yet a present obligation because an entity can, in theory, avert that obligation by ceasing or changing its method of operating.

24. In the Exposure Draft *Conceptual Framework for Financial Reporting*, published May 2015 (the *Conceptual Framework* ED), a liability is defined as:

> A liability is a present obligation of the entity to transfer an economic resource as a result of past events.[3]

[2] The *Conceptual Framework for Financial Reporting*, paragraph 4.4(b).

[3] The *Conceptual Framework* ED, paragraph 4.4.

25. On the face of it, this does not change the way that the existing definition has been interpreted, as described in paragraph 22. However, the *Conceptual Framework* ED provides some additional guidance about the meaning of 'present obligation', which is not contained in the existing *Conceptual Framework*. This guidance states:

> An entity has a present obligation to transfer an economic resource if both:
>
> (a) the entity has no practical ability to avoid the transfer; and
>
> (b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.[4]

26. In some cases, a participant may decide to close down its production facility because the cost of complying with the scheme is considered too high. However, using the Conceptual Framework ED proposals, we do not think that the ability to make this decision would not prohibit the entity from recognising the obligation to remit the allocated allowance to the government. This is because paragraphs 4.32-4.33 of the *Conceptual Framework* ED note that an entity has no practical ability to avoid a transfer if:

(a) the transfer could only be avoided by ceasing trading; or

(b) any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself.

27. Cases in which a participant closes down its production facility to avoid the obligation to remit the allocated allowances are expected to be rare. Indeed, if many participants were to take this course of action, it would not only create a surplus of allowances in the market, which would reduce significantly the market price of allowances, but it could also be seriously damaging to the country's economy as a whole. As noted in paragraph 7, in order to avoid such adverse

[4] The *Conceptual Framework* ED, paragraph 4.31. Further guidance on 'no practical ability to avoid the transfer' and 'past event' is contained in the Conceptual Framework ED, paragraphs 4.32-4.39. For convenience, these paragraphs are reproduced in Appendix 2.

economic effects, governments take into consideration the likely effect of the scheme on production levels when designing the scheme.

28. In the case of allocated allowances received by a participant in a cap-and-trade ETS, it can be argued that:

    (a) the entity has no practical ability to avoid the transfer of all or some of the allocated allowances, which have been allocated based on historical and expected future emissions levels; and

    (b) the entity has already received the economic benefits that establish the extent of its obligation; that it, the entity has received the allocated allowances. The entity may sell them in the market or use them as security for borrowings.

29. Some suggest that the inability of the entity to avoid the transfer of the allocated allowances back to the government means that the allocation of allowances to the entity is akin to the granting of an interest-free loan from the government: the entity receives the allowances but is then obliged to return them at a later date. In this context, the loan is considered to be interest-free because the terms of the loan require repayment of the same number of allowances, without any adjustment for the time value of money. The quantity of allowances that the entity must remit to the government is based on the quantity of emissions made. If the entity reduces its emissions so that it needs to remit fewer allowances than the quantity allocated to it, this may be considered to reflect the forgiveness of part of the loan. Guidance on the accounting treatment for loans from government that are forgivable or are granted at a below-market rate of interest is contained in paragraphs 10-10A of IAS 20. We will consider the implications of this guidance at a later date.

30. When the entity expects to emit exactly the same quantity of emissions as the allocated allowances received from the government, there is a fully effective hedge. In this case, there should be no gain or loss recognised either on day 1 or during the compliance period. In order to faithfully represent this effective hedge, the allocated allowances and the day 1 liability will need to be measured subsequently on the same basis.

Subsequent accounting for the day 1 liability

31. As noted in paragraph 12(a), many ASAF members suggest that we should explore an accounting model that recognises the allocated allowances as assets and measures them, both initially and subsequently, at fair value. In this paper, we have used this as the basis of the model under consideration. In order to faithfully represent the effectiveness of the hedging relationship between the quantity of allocated allowances received and the quantity of emission made, the day 1 liability would need to be remeasured subsequently, on the same basis as the allocated allowances that provide the effective hedge.

32. If it is accepted that the liability for the remittance of the allocated allowances is similar to a loan liability, we consider that it is acceptable to remeasure it at each reporting date. We think that the allowances can be viewed as a type of currency unit; that is, the loan is denominated in 'allowance units' because it is settled by the entity remitting a quantity of allowances, which have a variable value.

33. If the quantity of allowances that are needed to settle the liability exactly equals the quantity of allocated allowances received, the hedge is fully effective in quantity terms. Remeasuring both the liability and the allowances at the fair value of the allowances would reflect that the hedge is fully effective in value terms and would result in no gain or no loss being recognised in profit or loss. The result is similar to what occurs when an entity holds a monetary asset and a monetary liability of equal amount and both are denominated in the same foreign currency: when the exchange rate changes, the carrying amounts of the monetary asset and monetary liability change by the same amount, and there is no net income or expense.

Gradual replacement of the day 1 liability with a liability for actual emissions

34. If it is accepted that the liability for the remittance of the allocated allowances is similar to a loan liability, the actual emissions may be considered to be merely confirming the obligation to remit the allowances to the government and so no further accounting entries are needed, unless the quantity of emissions expected is different from the quantity of allocated allowances received.

35. However, as noted in paragraphs 17-18, the day 1 credit balance has traditionally been viewed as a form of deferred income and has been amortised to profit or loss at the same time that a liability for the actual emissions made to date is accrued. This results in the gradual replacement of the day1 credit balance with a liability based on actual emissions. Some may prefer to retain this replacement approach so that the liability relating to the actual emissions made to date can be more readily identified.

36. The different effects of replacing the day 1 liability with an accruing liability for actual emissions compared to retaining the classification of the day 1 liability are demonstrated in Year 1 of the example in Appendix 4.

37. In the following paragraphs, we consider how to recognise the differences between the quantity of allocated allowances and the expected quantity of emissions to be made.

An ineffective hedge—emissions are expected to exceed allocated allowances

38. Although the initial allocation of allowances from the government will be based on the entity's historical and expected level of emissions, the quantity of pollutants expected to be emitted during the compliance period is unlikely to exactly equal the quantity of allocated allowances received. This creates a partially ineffective hedge, which will result in a gain or loss being recognised in profit or less. The question is: when should that gain or loss be recognised?

39. In some cases, the entity will expect to emit more pollutants than the quantity of allocated allowances received from the government. Consequently, the entity will need to recognise an expense for the cost (or expected cost) of the excess emissions. There are two views about when the expense should be recognised in profit or loss:

    (a) View 1—only after the quantity of emissions exceeds the quantity of allocated allowances; or

    (b) View 2—gradually throughout the year, as the entity emits.

40. This agenda paper is focussing on cap-and-trade ETS liabilities. At a later date we will consider when an asset could be recognised in situations in which an entity may expect to emit fewer emissions that the quantity of allocated allowances that is has received from the government.

View 1—do not recognise until after the threshold is reached

41. Those who support view 1 suggest that this is a very similar situation to that addressed in IFRIC Interpretation 21 *Levies* (IFRIC 21) paragraph 12, which states:

> If an obligation to pay a levy is triggered when a minimum threshold is reached, the accounting for the liability that arises from that obligation shall be consistent with the principles established in paragraphs 8–14 of this Interpretation (in particular, paragraphs 8 and 11). For example, if the obligating event is the reaching of a minimum activity threshold (such as a minimum amount of revenue or sales generated or outputs produced), the corresponding liability is recognised when that minimum activity threshold is reached.

42. IFRIC 21 addresses levies that become payable only if and when a series of activities have all occurred. It applies the principle in paragraph 19 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* that an obligation must exist independently of the entity's future actions. IFRIC 21 states that the event that gives rise to an obligation to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. There may be earlier activities that are also necessary for a levy to be payable, but because they are not sufficient by themselves to trigger the payment, they are not obligating events.

43. Using this view, the entity would recognise no expense in profit or loss until it had emitted above the quantity of allocated allowances. From that point onwards, it would recognise an expense corresponding to the level of actual emission made over time.

View 2—recognise the liability for the ineffective hedge as emissions occur throughout the period

44. Those who support view 2 suggest that an obligation arises as soon as the entity starts to emit the specified pollutants. This is because the activities that result in the entity exceeding the emissions threshold, that is the quantity of allocated allowances, is a continuous event and not a succession of discrete events. In order to reach the emissions threshold, the entity firstly has to generate the quantity of emission that equal the quantity of allowances allocated. Consequently, although the measurement of the excess emissions liability is based on the quantity of emissions above the threshold, the obligation itself arises as a result of the activities that have produced the emissions throughout the whole period. Supporters of view 2 suggest that, in the context of the guidance in paragraph 4.31 of the Conceptual Framework ED (see paragraph 25 of this paper), the extent of the entity's obligation to remit allowances to the government is established as emissions are made, not just when the quantity of the allocated allowances has been exceeded.

45. Under view 2, the entity would start to accrue a liability on a systematic basis over time, based on the amount of actual emissions made as a proportion of the total expected emissions for the year. This reflects the view that all emissions contribute to the overall cost of exceeding the quantity of allocated allowances.

46. The different effects of views 1 and 2 are demonstrated in Year 2 of the example in Appendix 4.

Implications of the Conceptual Framework proposals

47. In July 2015, ASAF members discussed the status of IASB staff research on provisions, contingent liabilities and contingent assets (IAS 37). This included consideration of the possible implications of the Conceptual Framework ED proposals that might guide the IASB's decisions if those proposals are finalised and if the IASB takes on a project to amend aspects of IAS 37. An extract from ASAF Agenda Paper 4C *Implications of the* Conceptual Framework *proposals* relating to IFRIC 21 is reproduced in Appendix 3.[5]

[5] The same paper was presented to the IASB in July 2015, referenced Agenda Paper 14C.

Questions for the ASAF

Questions for the ASAF

1. Do members of the ASAF agree that the ‘day 1 credit balance’ could satisfy the definition of a liability, using the criteria and guidance proposed in the Conceptual Framework ED? Why or why not?

2. If it is accepted that the day 1 credit balance does satisfy the definition of a liability, do members of the ASAF think that the day 1 liability should be replaced by an accruing liability as the actual emissions made? Why or why not?

3. When an entity expects to emit more emissions than the quantity of allocated allowances received, when do ASAF members think that the provision for the expected excess emissions should be accrued? Should it be:
   (a) only when the quantity of allocated allowances has been exceeded, or
   (b) throughout the whole period, as emissions are made?

   Why?

Next steps

48. The staff will take the views of ASAF members into account when analysing any possible models that the IASB would like to explore in more detail through the Discussion Paper. This analysis will involve a more detailed comparison to the concepts in the *Conceptual Framework* ED and the existing requirements of IFRS.

Appendix 1: Extract from the July 2015 ASAF Meeting summary

Pollutant pricing mechanisms (formerly emissions trading schemes)

65. At this meeting, the ASAF members:

    a. focussed on a cap-and-trade type of emissions trading scheme (ETS); and

    b. provided views about possible accounting approaches using a simple example of a cap-and-trade ETS. The example and some possible approaches are contained in ASAF Agenda Paper 7B.

66. The member from China introduced Agenda Paper 7C *China's New Proposal on Accounting for Emission Trading Schemes*, which uses the same example as the one contained in Agenda Paper 7B to demonstrate an additional possible approach. The approach suggests:

    a. When a participant entity receives allowances from the government free of charge, it should recognise the allowances at fair value but also recognise a liability for the same amount. This liability would represent the obligation to comply with the scheme (see paragraph 7).

    b. As the entity emits the specified pollutants, it creates an obligation to remit allowances back to the government, equal in quantity to the volume of pollutants emitted. This obligation should be recognised as a liability, measured at the present value of the allowances. This liability gradually replaces the initial liability recognised.

    c. The allowances asset and the two liabilities would subsequently be measured at fair value, with the remeasurement being recognised in profit or loss.

    d. If, as in the simple example, the volume of pollutants emitted equals the quantity of allowances received free of charge from the government, there is a fully effective hedge. As a result, there will be no gain or loss to recognise in profit or loss.

    e. If the volume of pollutants emitted does not, or is not expected to, equal the quantity of allowances received free of charge, there is an ineffective hedge. Using the proposed approach, a gain or loss resulting from the ineffective portion of the hedge will be recognised in profit or loss.

67. ASAF members generally agreed that the introduction of a cap-and-trade ETS imposed new restrictions and potential costs on a participant entity. Consequently, most members think that recognising a 'Day 1 gain' in profit or loss would not faithfully represent the economics of the scheme. The allocation of allowances free of charge from the

government should not result in a gain; instead, many members consider that it is a mechanism designed to reduce the entity's costs imposed by the scheme, or an incentive to encourage reduction of emissions.

68. Many ASAF members expressed a preference for an approach that would result in no gain or loss being recognised in profit or loss during the compliance year, when there is a fully effective hedge between the quantity of pollutants emitted and the allowances allocated free of charge by the government.

69. Many ASAF members support measuring the allowances at fair value. This approach recognises that that the allowances can be used to generate cash, as well as to settle the obligation to remit allowances to the government equal to the volume of pollutants emitted. This, in effect, considers the allowances to be similar to a 'foreign currency'.

70. Many ASAF members also support measuring at fair value the liability to remit allowances to the government equal to the volume of pollutants to be emitted. This, it is suggested, is consistent with a liability recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

71. A question remained about how to describe the initial liability described in Agenda Paper 7C (see paragraph 2(a)) and how it fits the definition of a liability in the *Conceptual Framework*. The IASB staff will carry out a further analysis to bring to a future ASAF meeting.

72. Some ASAF members expressed a preference for Approach 5 in Agenda Paper 7B. In this approach, the allowances and related liabilities would be measured using a historical cost approach, instead of remeasuring them at fair value. In cases in which the allowances are measured at nil because they were received free of charge from the government, this would effectively result in the allowances and related liabilities not being recognised in the financial statements.

73. Some ASAF members suggested that this approach is less transparent and provides less useful information to users of financial statements. They suggest that recognising the allowances and related liabilities separately and measuring the allowances at fair value would more faithfully represent the choices that the entity has available when deciding whether and when to trade or hold allowances . Separate recognition could also support better understanding of the entity's obligations, if the government were to change its policy on providing allowances.

74. Some ASAF members suggested a 'business model' approach. Allowances that are held for trading would be measured at fair value through profit or loss. Allowances that are held for compliance purposes to settle the entity's obligation to remit allowances to the government equal to the volume of pollutants emitted would be measured at historical cost. In cases in which an entity receives, free of charge, an allocation of allowances from

the government that it will use for compliance purposes, instead of selling the allowances through the market, one ASAF member did not believe that the allocation creates an asset or a liability. Many ASAF members consider that using a business model approach (distinguishing allowances held for compliance from allowances held for trading) would add complexity to the model and create difficult accounting issues in cases in which management intention changes or allowances are used for both trading and compliance purposes through the reporting period.

Next steps

75. The IASB staff will bring proposals for an accounting model (or models) to a future ASAF meeting, together with an analysis of how the model(s) fits the *Conceptual Framework* and existing IFRS.

Appendix 2: Extract from the *Conceptual Framework* ED

No practical ability to avoid the transfer

4.32 An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. It is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

4.33 If an entity prepares financial statements on a going concern basis, the entity:

(a) has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or ceasing trading; but

(b) has the practical ability to avoid (and hence does not have a liability for) a transfer that would be required only on the liquidation of the entity or on the cessation of trading.

4.34 Many obligations are legally enforceable as a consequence of a contract, legislation or similar means. Obligations can also arise, however, from an entity's customary practices, published policies or specific statements that require the transfer of an economic resource. If the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements, the entity has an obligation. The obligation that arises in such situations is often described as a constructive obligation.

4.35 In some situations, the requirement for an entity to transfer an economic resource may be expressed as being conditional on a particular future action by the entity, such as conducting particular activities or exercising particular options within a contract. The entity has an obligation if it has no practical ability to avoid that action.

Past event

4.36 An entity has a present obligation as a result of a past event only if it has already received the economic benefits, or conducted the activities, that establish the extent of its obligation. The economic benefits received could include, for

example, goods or services. The activities conducted could include, for example, operating in a particular market. If the economic benefits are received, or the activities are conducted, over time, a present obligation will accumulate over time (if, throughout that time, the entity has no practical ability to avoid the transfer).

4.37 An event establishes the extent of an obligation if it specifies either the amount of the future transfer or the basis for determining that amount. For example, an insurer may enter into a contract to provide insurance coverage in return for a single premium. When the insurer receives the premium, it has an obligation to provide insurance coverage because:

(a) although the amount of any future transfer still depends on whether an insured event occurs, the insurer has no practical ability to avoid transferring an economic resource if an insured event occurs; and

(b) the insurer has received the premium that establishes that it must provide coverage to the extent specified by the contract, and this provides the basis for determining the amount of any future transfer.

4.38 A present obligation can exist at the end of the reporting period even if the transfer of economic resources cannot be enforced until some point in the future. For example, a financial liability may not require a payment to be made until a future date. The payment cannot be enforced until that future date, but the liability exists now. Similarly, a contractual obligation for the entity to perform work at a future date cannot be enforced by the counterparty until that future date, but the obligation arising from the contract exists now if the counterparty has already paid for the work (see paragraphs 4.40–4.42).

4.39 An entity does not have a present obligation for the costs that will arise if it will receive benefits, or conduct activities, in the future (for example, the costs of future operations); the extent of the future transfer will not be determined by reference to benefits that the entity has received, or activities that it has conducted, in the past. If the entity has entered into a contract that is still executory, the entity may have a present right and obligation to exchange economic resources in the future (see paragraphs 4.40–4.42).

Appendix 3: Extract from ASAF Agenda Paper 4C *Implications of* Conceptual Framework *proposals*, July 2015

Implications for levies

IFRIC 21 identifies liabilities only when obligations become unconditional

1.5 IFRIC 21 addresses levies that become payable only if and when a series of activities have all occurred. It applies the principle in paragraph 19 of IAS 37 that an obligation must exist independently of the entity's future actions. IFRIC 21 states that the event that gives rise to an obligation to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. There may be earlier activities that are also *necessary* for a levy to be payable, but because they are not *sufficient* by themselves to trigger the payment, they are not obligating events.

1.6 The consensus includes an example in which the activity that triggers the payment of a levy is the generation of any revenue in the *current* period, and the calculation of that levy is based on the amount of revenue that was generated in the *previous* period. The consensus states that the obligating event for that levy is the generation of revenue in the current period. The generation of revenue in the previous period is necessary, but not sufficient, to trigger payment of a levy.[6]

1.7 In reaching its consensus, the IFRS Interpretations Committee considered an alternative view, ie that an obligation arises as soon as the amount of a levy starts to accumulate if the entity would have to take an unrealistic action (such as ceasing operations) to avoid the future activity that will trigger the levy. The basis of this view was that, in such situations, the entity is economically compelled to continue to operate and so will have no realistic alternative to paying the levy.

1.8 However, the Interpretations Committee rejected the argument on the basis that, if this rationale were applied, many types of future expenditure would be recognised as liabilities. The Interpretations Committee noted in particular the statement in

[6] IFRIC 21, paragraph 8.

IAS 37 that no provision is recognised for costs that need to be incurred to operate in the future.[7]

The result can be that a liability and an expense are recognised at a point in time

1.9 The requirements of IFRIC 21 lead to liabilities for some recurring periodic levies (such as the levy described in paragraph 1.6) being recognised in full at a point in time. The Interpretations Committee considered whether in some cases, the cost of the levy also gives rise to an *asset*—such as a licence to operate for the period. If so, the cost of the levy would not be recognised as an expense at that point in time. Instead, it would be recognised as an expense when the asset is amortised, which would be over the period up to the date of the next charge.

1.10 However, the Interpretations Committee decided that IFRIC 21 should not address the accounting treatment of the cost side of the transaction because other Standards (such as IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*) would determine whether the recognition of a liability to pay a levy gives rise to an asset or an expense.[8]

1.11 In practice, it is often not possible to identify an asset that is received by the entity in exchange for paying a levy and capable of being recognised applying another Standard. Accordingly, many levies that are recognised as liabilities at a single point in time must also be recognised as expenses at that point in time.

Stakeholders think IFRIC 21 does not faithfully represent periodic levies

1.12 IFRIC 21 has been criticised by a range of stakeholders, including users, preparers and auditors of financial statements and national standard-setters. Many of those criticising IFRIC 21 accept that it is a valid interpretation of IAS 37, but:

(a) some think that, in combination with Standards addressing the identification and recognition of assets, IFRIC 21 results in information that does not give a faithful representation of an entity's financial position and performance. They think that the economic substance of a recurring levy is that the entity is paying to operate over a period, although the law may identify a different activity that triggers the payment (such as being in

[7] IFRIC 21, Basis for Conclusions, paragraphs BC15-BC19.

[8] IFRIC 21, paragraph BC11.

operation at a specified date). They think that the substance of a recurring levy would be more faithfully represented by recognising the expense over the period to which the levy refers.

(b) some note that the requirements of IFRIC 21 are not consistent with the requirements of other IFRSs that address similar issues. For example, IFRS 2 *Share-based Payments* requires entities to recognise liabilities for cash-settled share-based payments. It requires an entity to recognise a liability when it receives the goods or services acquired in exchange for the share-based payment—even if at that time the payment is still subject to vesting conditions. Vesting conditions could include future performance targets, such as growth in profit. In such situations, the entity recognises a liability while it could still, in theory at least, avoid the future payment through its future actions.[9]

(c) some note that the requirements of IFRIC 21 also appear to be inconsistent with the requirements for other transactions within the scope of IAS 37, such as restructuring costs.

The proposed concepts consider the entity's practical ability to avoid a transfer

1.13 The *Conceptual Framework* Exposure Draft proposes new concepts to explain the term 'present obligation'. It proposes that:

> 4.31 An entity has a present obligation to transfer an economic resource if both:
>
> (a) the entity has no practical ability to avoid the transfer; and
>
> (b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

1.14 The Exposure Draft notes that a present obligation could accumulate over time:

[9] IFRS 2 *Share-based Payments*, paragraph 7, and definition of 'performance condition' in Appendix A.

> 4.36 … If the economic benefits are received, or the activities are conducted, over time, a present obligation will accumulate over time (if, throughout that time, the entity has no practical ability to avoid the transfer).

1.15 The Exposure Draft proposes further guidance for situations in which the event that will trigger the transfer has not yet occurred:

> 4.35 In some situations, the requirement for an entity to transfer an economic resource may be expressed as being conditional on a particular future action by the entity, such as conducting particular activities or exercising particular options within a contract. The entity has an obligation if it has no practical ability to avoid that action.

1.16 The Exposure Draft also proposes to clarify the meaning of 'no practical ability':

> 4.32 An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. It is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

1.17 Thus, economic compulsion as discussed in paragraph 1.7 could be a factor in assessing whether an entity has the practical ability to avoid a future transfer. However, an inability to avoid a future transfer is not the only criterion for a present obligation—it is also necessary that the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation. Hence, economic compulsion alone is insufficient to create a liability.

Applying the proposed concepts, liabilities for some periodic levies would be recognised incrementally over the period to which the levy refers

1.18 I think that if the IASB were to apply the proposed new concepts to levies, it would specify requirements different from those in IFRIC 21: a liability might be identified before the entity conducts the activity that triggers payment of the levy. A liability would be identified earlier if:

(a) the amount of the levy is established by reference to earlier activities; and

(b) having conducted those earlier activities, the entity has no practical ability to avoid the future activities that will trigger the levy.

1.19 In the example discussed in paragraph 1.6, the obligating event *could* be the generation of revenue in the earlier period, with the liability accumulating over that period as the entity recognises the revenue on which the calculation of the levy is based. This earlier generation of revenue *would* be the obligating event if the entity judges that it has no practical ability to avoid generating further revenue in the next period. In many cases, the economic consequences of generating no revenue in the next period could be significantly more adverse than paying the levy and, accordingly, the entity might reach a judgement that it has no practical ability to avoid the levy.

Appendix 4: Example demonstrating the alternative approaches referred to in paragraphs 35 and 46.

A4.1. To demonstrate the different effects of the options described in paragraphs 31-35 and 38-45, the following simplified fact pattern is provided for a participant in a cap-and-trade style emissions trading scheme (ETS). The fact pattern is based on that used in Appendix C of the ASAF Agenda Paper 6B *Comparison of possible approaches—a simplified example*, July 2015. The example has been modified, partly to simplify the numbers in order to focus on the principles, and partly to extend the example into a second year to demonstrate different aspects.

(a) Entity 1 is a participant in a new cap and trade scheme in which allowances are traded in an active market. The scheme operates for annual compliance periods that coincide with Entity 1's reporting periods.

(b) On 1 January, Year 1, Entity 1 receives, free of charge, allowances for the year equivalent to 6,000 tonnes of carbon dioxide equivalents (tCO2e). It expects its emissions for the whole year to be 6,000 tonnes (ie equal to the allowances issued to it). Entity 1 emits emissions on a straight-line basis every month.

(c) On 1 January, Year 2, Entity 1 receives, free of charge, allowances for the year equivalent to 5,400 tCO2e. It expects its emissions for the whole year to be 6,000 tCO2e. Entity 1 emits emissions on a straight-line basis every month. On 31 December, Year 2 Entity 1 buys 600 tCO2e, which is equal to the shortfall of allocated allowances.

Year 1

A4.2. In year 1, there is a fully effective hedge because the quantity of actual emissions equals the quantity of allocated allowances. The tables for Year 1 show the monthly emissions and changes in market value of allowances, together with the resulting effects in the profit or loss account and in the statement of financial position. Two views are demonstrated:

(a) When the entity actually emits the pollutants during the compliance period, the day 1 liability (termed *the day 1 liability*) is gradually replaced by accruing provision for the actual emissions made (termed *the emissions liability*). This is termed the *replacement model*.

(b) When the entity actually emits the pollutants during the compliance period, this is considered to merely confirm the day 1 liability and so no further accounting entries are made as the emissions are made. This is termed the *non-replacement model*.

Year 2

A4.3. In year 2, there is a partially ineffective hedge because the entity expects to emit 600 units of emissions in excess of the 5,400 allocated allowances received. The additional 600 allowances that the entity needs to remit to the government are acquired in the market on 31 December. The tables for Year 2 show the monthly emissions and changes in market value of allowances, together with the resulting effects in the profit or loss account and in the statement of financial position. Two views are demonstrated:

(a) View 1—the expense is recognised in profit or loss only at the time when the quantity of emissions exceeds the quantity of allocated allowances

(b) View 2—the expense is recognised in profit or loss gradually throughout the compliance period, as the entity emits.

A4.4. In Year 2, the amount of the total liability and the total profit or loss would be the same when using both the replacement and non-replacement models (see paragraph A4.2). However, in the replacement model, the total liability amount would need to be allocated between the two types of liability, that is the reducing day 1 liability and the emissions liability.

A4.5. To reduce the volume of data presented in the following tables, only the non-replacement model is used to demonstrate the two views in Year 2. In this case, the day 1 liability remains unchanged and a separate emissions liability is created for the excess emissions.

Replacement Model—Year 1

Year 1														Total
Month	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	
Allocated Allowances	6,000													**6,000**
Actual Emissions (tCO2e)		500	500	500	500	500	500	500	500	500	500	500	500	**6,000**
Market Price (CU)	10	11	12	14	10	9	12	8	9	8	10	11	9	
Allowances (assets)[1]														
Quantity (tCO2e)	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	
Value (CU)	60,000	66,000	72,000	84,000	60,000	54,000	72,000	48,000	54,000	48,000	60,000	66,000	54,000	
Total liabilities[1, 2]														
Quantity (tCO2e)	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*	
Value (CU)	*60,000*	*66,000*	*72,000*	*84,000*	*60,000*	*54,000*	*72,000*	*48,000*	*54,000*	*48,000*	*60,000*	*66,000*	*54,000*	
Day 1 liability[3]														
Quantity (tCO2e)	6,000	5,500	5,000	4,500	4,000	3,500	3,000	2,500	2,000	1,500	1,000	500	0	
Value(CU)	60,000	60,500	60,000	63,000	40,000	31,500	36,000	20,000	18,000	12,000	10,000	5,500	0	
Emissions liability														
Quantity (tCO2e)	0	500	1,000	1,500	2,000	2,500	3,000	3,500	4,000	4,500	5,000	5,500	6,000	
Value (CU)	0	5,500	12,000	21,000	20,000	22,500	36,000	28,000	36,000	36,000	50,000	60,500	54,000	
Remeasurement gains (losses)	0	0	0	0	0	0	0	0	0	0	0	0	0	**0**
Emission gains (expenses)	0	0	0	0	0	0	0	0	0	0	0	0	0	**0**
Total profit/ (loss)	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**

[1] Both the allowances and the liabilities are measured at the fair value (market price) of allowances at each reporting date.

[2] The total liability is the sum of the day 1 liability and the emissions liability.

[3] Each month, the day 1 liability is reduced by the quantity of emission recognised in the emissions liability ($500tCO_2$ per month)

Non-Replacement Method—Year 1

Year 1														Total
Month	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	
Allocated Allowances	6,000													**6,000**
Actual Emissions(tCO2e)		500	500	500	500	500	500	500	500	500	500	500	500	**6,000**
Market Price(CU)	10	11	12	14	10	9	12	8	9	8	10	11	9	
Allowances (assets)[1]														
Quantity(tCO2e)	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	
Value(CU)	60,000	66,000	72,000	84,000	60,000	54,000	72,000	48,000	54,000	48,000	60,000	66,000	54,000	
Total liabilities[1,2]														
Quantity (tCO2e)	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	
Value (CU)	60,000	66,000	72,000	84,000	60,000	54,000	72,000	48,000	54,000	48,000	60,000	66,000	54,000	
Day 1 liability														
Quantity (tCO2e)	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	
Value (CU)	60,000	66,000	72,000	84,000	60,000	54,000	72,000	48,000	54,000	48,000	60,000	66,000	54,000	
Emissions liability														
Quantity (tCO2e)	0	0	0	0	0	0	0	0	0	0	0	0	0	
Value (CU)	0	0	0	0	0	0	0	0	0	0	0	0	0	
Remeasurement gains (losses)	0	0	0	0	0	0	0	0	0	0	0	0	0	**0**
Emission gains (expenses)	0	0	0	0	0	0	0	0	0	0	0	0	0	**0**
Total profit/ (loss)	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**

[1] Both the allowances and the liabilities are measured at the fair value (market price) of allowances at each reporting date.

[2] The total liability is the sum of the day 1 liability and the emissions liability.

Summary comparison of the replacement model and non-replacement model—Year 1

	Replacement model					Non-replacement model			
Statement(s) of profit or loss[1]	**Date of allocation**	**6 months to 30 June**	**6 months to 31 Dec.**	**Full year**		**Date of allocation**	**6 months to 30 June**	**6 months to 31 Dec.**	**Full year**
	CU	**CU**	**CU**	**CU**		CU	CU	CU	CU
Remeasurement gains/ (losses)		0	0	0			0	0	0
Emission gains/ (expenses)		0	0	0			0	0	0
Profit/ (loss)		0	0	0			0	0	0
Statement of financial position	**Date of allocation**	**30-Jun**		**31-Dec**		**Date of allocation**	**30-Jun**		**31-Dec**
Assets									
Allowances	60,000	72,000		54,000		60,000	72,000		54,000
Liabilities-total	**60,000**	**72,000**		**54,000**		**60,000**	**72,000**		**54,000**
Day 1 liability	60,000	36,000		0		60,000	72,000		54,000
Emissions liability	0	36,000		54,000		0	0		0

[1] In year 1, the allocated allowances are equal to the quantity of actual emissions. The allocated allowances fully hedge the entity's obligation to remit allowances to the government, resulting in no gain or loss during the year.

Non-Replacement Method—year 2: View 1—expense recognised only after the allowance allocation is exceeded

Year 2—view 1														Total
Month	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	
Allocated Allowances	5,400													**5,400**
Actual Emissions (tCO2e)		500	500	500	500	500	500	500	500	500	500	500	500	**6,000**
Market Price (CU)	9	11	10	12	11	10	12	13	12	14	12	10	12	
Allowances (assets)[1]														
Quantity (tCO2e)	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	6,000[5]	
Value (CU)	48,600	59,400	54,000	64,800	59,400	54,000	64,800	70,200	64,800	75,600	64,800	54,000	72,000	
Total liabilities[1, 2]														
Quantity (tCO2e)	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,500	6,000	
Value (CU)	48,600	59,400	54,000	64,800	59,400	54,000	64,800	70,200	64,800	75,600	64,800	55,000	72,000	
Day 1 liability														
Quantity (tCO2e)	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	
Value (CU)	48,600	59,400	54,000	64,800	59,400	54,000	64,800	70,200	64,800	75,600	64,800	54,000	64,800	
Emissions liability														
Quantity (tCO2e)	0	0	0	0	0	0	0	0	0	0	0	100	600	
Value (CU)	0	0	0	0	0	0	0	0	0	0	0	1,000	7,200	
Remeasurement gains/ (losses)[3]	0	0	0	0	0	0	0	0	0	0	0	0	(200)	**(200)**
Emission gains/ (expenses)[4]	0	0	0	0	0	0	0	0	0	0	0	(1,000)	(6,000)	**(7,000)**
Total profit/ (loss)	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**(1,000)**	**(6,200)**	**(7,200)**

[1] Both the allowances and the liabilities are measured at the fair value (market price) of allowances at each reporting date.
[2] The total liability is the sum of the day 1 liability and the emissions liability.
[3] The remeasurement gain/ (loss) results from the remeasurement of the previous month's emissions liability to the current month-end market price.
[4] For simplicity, the monthly expense is measured as the quantity of emissions multiplied by the spot price of allowances at the end of the month.
[5] The entity buys 600 allowances in the market on 31 December for CU12 each.

Non-Replacement Method—year 2: View 2—expense recognised throughout the period as the entity emits

Year 2—view 2														Total
Month	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	
Allocated Allowances	5400													**5,400**
Actual Emissions(tCO2e)		500	500	500	500	500	500	500	500	500	500	500	500	**6,000**
Market Price(CU)	9	11	10	12	11	10	12	13	12	14	12	10	12	
Allowances (assets)[1]														
Quantity (tCO2e)	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	6,000[5]	
Value (CU)	48,600	59,400	54,000	64,800	59,400	54,000	64,800	70,200	64,800	75,600	64,800	54,000	72,000	
Total liabilities[1,2]														
Quantity (tCO2e)	5,400	5,450	5,500	5,550	5,600	5,650	5,700	5,750	5,800	5,850	5,900	5,950	6,000	
Value (CU)	48,600	59,950	55,000	66,600	61,600	56,500	68,400	74,750	69,600	81,900	70,800	59,500	72,000	
Day 1 liability														
Quantity (tCO2e)	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	5,400	
Value (CU)	48,600	59,400	54,000	64,800	59,400	54,000	64,800	70,200	64,800	75,600	64,800	54,000	64,800	
Emissions liability														
Quantity (tCO2e)	0	50	100	150	200	250	300	350	400	450	500	550	600	
Value (CU)	0	550	1,000	1,800	2,200	2,500	3,600	4,550	4,800	6,300	6,000	5,500	7,200	
Remeasurement gains/ (losses)[3]	0	0	50	(200)	150	200	(500)	(300)	350	(800)	900	1,000	(1,100)	**(250)**
Emission gains/ (expenses)[4]	0	(550)	(500)	(600)	(550)	(500)	(600)	(650)	(600)	(700)	(600)	(500)	(600)	**(6,950)**
Total profit/ (loss)	**0**	**(550)**	**(450)**	**(800)**	**(400)**	**(300)**	**(1,100)**	**(950)**	**(250)**	**(1,500)**	**300**	**500**	**(1,700)**	**(7,200)**

[1] Both the allowances and the liabilities are measured at the fair value (market price) of allowances at each reporting date.
[2] The total liability is the sum of the day 1 liability and the emissions liability.
[3] The remeasurement gain/ (loss) results from the remeasurement of the previous month's emissions liability to the current month-end market price.
[4] For simplicity, the monthly expense is measured as the quantity of emissions multiplied by the spot price of allowances at the end of the month.
[5] The entity buys 600 allowances in the market on 31 December for CU12 each.

Summary comparison of views 1 and 2 with the Non-replacement Method—Year 2

	Year 2—view 1					Year 2—view 2			
Statement(s) of profit or loss[1]	**Date of allocation**	**6 months to 30 June**	**6 months to 31 Dec.**	**Full year**		**Date of allocation**	**6 months to 30 June**	**6 months to 31 Dec.**	**Full year**
	CU	CU	CU	CU		CU	CU	CU	CU
Remeasurement gains (losses)		0	(200)	(200)			(300)	50	(250)
Emission gains (expenses)		0	(7,000)	(7,000)			(3,300)	(3,650)	(6,950)
Profit/(loss)		0	(7,200)	(7,200)			(3,600)	(3,600)	(7,200)
Statement of financial position	**Date of allocation**	**30-Jun**		**31-Dec**		**Date of allocation**	**30-Jun**		**31-Dec**
Assets									
Allowances (assets)	48,600	64,800		72,000		48,600	64,800		72,000
Liabilities	**48,600**	**64,800**		**72,000**		**48,600**	**68,400**		**72,000**
Day 1 liability	48,600	64,800		64,800		48,600	64,800		64,800
Emissions liability	0	0		7,200		0	3,600		7,200

[1] In year 2, the allocated allowances are fewer than the quantity of actual emissions. The allocated allowances provide a partial hedge for the entity's obligation to remit allowances to the government. The resulting loss for the year reflects the entity's additional obligation to remit an extra 600 allowances to the government and the entity's exposure to market price fluctuations prior to buying the additional allowances on 31 December.