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FASB Proposes Guidance on Environmental Credits

On December 17, 2024, FASB issued an exposure draft requesting feedback on the creation of a new Accounting Standards Codification (ASC) Topic 818, *Environmental Credits and Environmental Credit Obligations,* which would provide authoritative guidance on recognition, measurement, presentation, and disclosure of environmental credits and environmental credit obligations. Comments are requested by April 15, 2025.

Background

As environmental credits and related regulatory compliance programs grow in popularity, stakeholders have requested authoritative accounting guidance on recognizing and measuring these credits. Currently, entities analogize to ASC 330, *Inventory*; ASC 350-30, *Intangibles—Goodwill and Other—General Intangibles Other than Goodwill*; and ASC 450, *Contingencies*, leading to diversity in practice.

Scope

The proposed guidance would apply to all entities that purchase, hold, or generate environmental credits or have a regulatory compliance obligation that may be settled with environmental credits.

Some examples of items that would be covered include:

- Emission allowances from domestic and global cap-and-trade programs
- Corporate Average Fuel Economy (CAFE) credits originating from U.S. CAFE standards
- Renewable identification numbers originating from the U.S. Renewable Fuel Standard
- Renewable energy certificates originating from U.S. State Renewable Portfolio Standards
- Carbon offsets

Some examples of items not covered by the proposal include:

- Renewable clean energy credits*
- Additional payment made for "carbon neutral" activities for which no credit is transferred
- Environmental remediation obligations within the scope of ASC 410-30

*These would continue to be accounted for under existing GAAP. **Resource**: Proportional Amortization Option for More Tax Credit Programs & LIHTC Accounting Changes

I. Environmental Credits (ECs)

Under the proposal, an EC is defined as follows:

An enforceable right that is acquired, internally generated, or granted by a regulatory agency or its designees, or received in a nonreciprocal transfer that is not a grant from a regulator or its designees that meets all the following criteria:

- Lacks physical substance and is not a financial asset.
- Is represented to prevent, control, reduce, or remove emissions or other pollution. This criterion was included to mitigate the risk that items not directly related to emissions or pollution, such as licenses or permits, would be included in scope.
- Is separately transferable in an exchange transaction. Neither the existence of an active market nor the length of time an item is transferable is a requirement to meet this criterion.
- Is not an income tax credit that may be used to settle an entity's income tax liability, regardless of whether the entity has a tax liability or intends to use the credit for that purpose.

An EC may be represented by a variety of forms, including—but not limited to—credits, certificates, allowances, and offsets.

Recognition & Measurement

An entity would recognize an EC as an asset when it is probable[1] that the EC will be used to settle an environmental credit obligation (ECO) or transferred to another party in an exchange transaction.

- ECs internally generated or received from a regulator or designee would be initially measured at the transaction costs incurred.
- Acquired ECs would be measured at cost or other applicable GAAP, *i.e.*, ASC 805, *Business Combinations*.
- ECs acquired for voluntary purposes (not probable to be transferred in an exchange transaction or used to settle an ECO) should be expensed as incurred as a nonrefundable deposit.

At each reporting period, an entity must reassess if the EC continues to meet the definition above. Subsequent measurement of EC assets would be based on their intended use:

- **Compliance ECs**. ECs that an entity is probable of using to settle an ECO would be classified as "Compliance ECs" and would not be subsequently remeasured (continue at cost) nor tested for impairment each reporting period.
- **Noncompliance ECs**. All other EC assets would be classified as "Noncompliance ECs" and subsequently measured at cost, with fewer impairment losses, if any. Impairment expense would be recognized when the carrying value of a noncompliance EC exceeds its fair value. Subsequent reversal of a previously recognized impairment loss would be prohibited.

If it is no longer probable that an EC will be used to settle an ECO or be transferred in an exchange transaction, the EC should be derecognized through earnings.

If the intended use of an EC changes (from a compliance to a noncompliance EC), an impairment test should be performed before applying the subsequent measurement guidance based on the new classification.

[1] Per the Master Glossary, "the future event or events are likely to occur."

A portfolio approach may be used for measurement if the ECs are so "sufficiently similar" that it would be unlikely an entity would recognize a significant loss if an individual EC were derecognized from the portfolio.

Fair Value Option

An entity could elect an accounting policy to measure a class of eligible noncompliance ECs at fair value, with subsequent changes recognized through earnings. To be eligible, the EC must have been obtained in an exchange transaction or a nonreciprocal transfer that is not a grant from a regulator or its designee. Recognition at fair value would continue until the credit is derecognized. If this policy is elected, it must be applied on a prospective basis.

Derecognition

If a compliance EC is remitted to a regulator to satisfy an ECO or if a noncompliance EC is transferred to another party in an exchange transaction, an entity should generally follow derecognition guidance in ASC 610-20, *Gains and Losses from the Derecognition of Nonfinancial Assets*.

II. Environmental Credit Obligation (ECO)

An ECO is defined as follows:

"A regulatory compliance obligation arising from existing or enacted laws, statutes, or ordinances represented to control, reduce, or remove emissions or other pollution that may be settled with environmental credits."

Obligations associated with environmental remediation liabilities (ASC 410-30, *Asset Retirement and Environmental Obligations – Asset Retirement Obligations*) are not ECOs, regardless of whether those obligations may be settled using ECs.

A company's voluntary climate pledges or goals would not meet the ECO definition since an obligation of an entity to itself does not create a liability under GAAP.

Recognition & Measurement

An entity would recognize an ECO liability when events, *e.g.*, emissions, occurring on or before the reporting date result in an ECO. An entity should assume that the reporting date is the end of the compliance period regardless of whether the compliance period ends on that date.

The initial and subsequent measure of an ECO liability would be the carrying amount of the entity's compliance ECs expected to settle the obligation at the reporting date (funded liability). If an entity has insufficient compliance ECs at the reporting date to cover the liability, the unfunded portion would be initially and subsequently measured at the fair value of the ECs necessary to settle the unfunded portion at the reporting date, with certain exceptions. An ECO liability would be derecognized when the ECs are remitted to a regulator.

III. Presentation & Disclosure

ECs should be reported separately from ECOs on the balance sheet. ECs expected to be transferred in an exchange transaction or remitted to a regulator within one year (or operating cycle if longer) would be classified as current assets. All other ECs would be considered noncurrent assets.

ECs

The following additional disclosures would be required.

Annual & Interim

- For each significant EC asset holding:
  - Description
  - Carrying amount
  - Classification (compliance, noncompliance)
  - Current and noncurrent assets portion of compliance and noncompliance ECs (if not separately presented on the balance sheet)
- Revenues from sales of ECs in contracts with customers and the EC carrying amount at the sale date.
- Gains and losses from sales of ECs to noncustomers and the EC carrying amount at the sale date.
- Total revenue (or gains) from sales of ECs that were never recognized as an asset or were previously derecognized.
- Total expense recognized for ECs not initially recognized as an asset or subsequently derecognized.
- Total impairment expense recognized during the reporting period and the nature of the ECs that were impaired and a description of the facts and circumstances giving rise to the impairment.
- The line item(s) in the income statement for the above revenue and expense items.
- Cash paid for ECs during the reporting period.

Annual

- An entity shall disclose the types of ECs owned and a description of the following:
  - How the entity obtains the ECs (acquired, granted, internally generated, or received in a nonreciprocal transfer)
  - How the entity uses or intends to use the ECs (sell or trade, to settle ECOs, or for voluntary purposes)
  - The entity’s method for subsequently measuring ECs recognized as assets (first-in, first-out, average cost, or specific identification)
  - If the entity accounts for ECs as a portfolio, how did the entity determine the portfolio(s)
  - Significant estimates and judgments used

An entity also would be required to provide the applicable fair value disclosures for noncompliance ECs measured at fair value under its accounting policy.

ECOs

Interim and annual reporting requirements would include information about significant ECO liabilities, current and noncurrent amounts of the funded and unfunded portions of ECO liabilities (if not separately presented on a classified balance sheet), and expenses related to ECO liabilities, disaggregated between accruals for emissions occurring and liability remeasurements during the reporting period. The applicable fair value disclosures for the unfunded portion of ECO liabilities also would be required. On an annual basis, the following information would be required:

- A description of regulatory compliance programs that the entity is subject to, including the nature, settlement provisions, types of ECs accepted as settlement, and activities that result in ECOs in those programs
- How the unfunded portion of an ECO liability is measured

Business Combinations

ECs acquired in a business combination should be recognized at the acquisition date and measured at fair value, regardless of the acquirer's intended usage. Subsequent measurements would follow the proposed guidance above. Acquired items that otherwise would have met the proposed definition of an EC but are not separately transferable would not be recognized as an asset in a business combination. Acquired ECOs would follow the guidance above.

Transition & Effective Date

An effective date will be determined after a review of comment letter feedback. A retrospective application would be required if finalized, and detailed transition guidance will be provided in the proposal. Early adoption would be permitted for interim and annual financial statements not yet issued or made available for issuance.

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Appendix

The following FASB flowchart illustrates the accounting for environmental credits.

Source: FASB