

To the Point

FASB – proposed guidance

FASB proposes establishing guidance on accounting for environmental credit programs

The proposal would apply to all entities that buy, receive or internally generate environmental credits that an entity plans to sell or trade, or use for compliance or voluntary purposes.

What you need to know

- ▶ The FASB proposed amendments that would establish guidance for the recognition, measurement, presentation and disclosure of environmental credits and environmental credit obligations.
- ▶ An entity would be required to capitalize or expense an environmental credit based on its planned use. Environmental credits probable of being sold or used to settle an environmental credit obligation would be recognized as an asset. The cost of all other environmental credits would be recognized as an expense.
- ▶ An entity would recognize a liability when events occurring on or before the reporting date result in an environmental credit obligation, which would generally be measured based on the carrying amount of certain environmental credits held at the balance sheet date and the fair value of environmental credits if the entity has insufficient credits to satisfy the liability.
- ▶ An entity would be required to disclose information about environmental credits and environmental credit obligations on an annual and interim basis.
- ▶ Comments are due by 15 April 2025.

Overview

The Financial Accounting Standards Board (FASB or Board) **proposed**¹ amendments that would establish requirements for the recognition, measurement, presentation and disclosure of environmental credits and environmental credit obligations. The proposal would apply to all



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entities that buy, receive or internally generate environmental credits that an entity intends to sell or trade, or use for compliance or voluntary purposes (e.g., for use in carbon-neutral or net-zero initiatives). The requirements would also apply to obligations arising from regulatory compliance programs.

The proposal specifies when an entity would recognize the cost of an environmental credit as an asset or an expense and, if it is recognized as an asset, how the entity would measure it. The proposal also specifies when an entity would recognize an environmental credit obligation liability and how those liabilities would be measured.

An entity would be required to disclose information about significant environmental credit asset holdings, significant environmental credit obligation liabilities and cash paid for environmental credits.

The proposal is intended to address stakeholder feedback that US GAAP does not provide specific guidance on how to recognize and measure environmental credits or the related obligations that result from regulatory compliance programs. Entities typically account for them by analogy to Accounting Standards Codification (ASC) 330, *Inventory*, ASC 350-30, *Intangibles – Goodwill and Other – General Intangibles Other Than Goodwill*, and ASC 450, *Contingencies*, which has resulted in diversity in practice.

Key considerations

Scope

Environmental credits

The proposal would apply to all environmental credits. An environmental credit would be defined as an enforceable right that is acquired, internally generated, 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 of the following criteria:

- ▶ It lacks physical substance and is not a financial asset.
- ▶ It is represented to prevent, control, reduce or remove emissions or other pollution.
- ▶ It is separately transferable in an exchange transaction.
- ▶ It 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.

The Board said this definition is intended to capture common types of environmental credits, including carbon offsets, renewable energy certificates (RECs), renewable identification numbers (RINs), European Union allowances (EUAs), and cap and trade allowances.

How we see it

Because income tax credits would be excluded from the definition of environmental credit, renewable energy tax credits, including those associated with the Inflation Reduction Act, would continue to be accounted for in accordance with other US GAAP.²

Environmental credit obligations

The proposal would apply to all environmental credit obligations, except for those in the scope of ASC 410-30, *Asset Retirement and Environmental Obligations – Environmental Obligations*. An environmental credit obligation would be defined as a regulatory compliance obligation arising from existing or enacted laws, statutes or ordinances represented to prevent, control, reduce or remove emissions or other pollution that may be settled with environmental credits.

Environmental credits that are not probable of being sold or used to settle an environmental credit obligation would be expensed.

The Board said this definition is intended to capture common regulatory compliance programs, including emission trading schemes, cap and trade programs, Renewable Portfolio Standard programs, Renewable Fuel Standard programs, and automotive emission programs. The definition would not include an entity's voluntary emission-reduction initiatives (e.g., net-zero and carbon-neutral initiatives), including those that it intends to satisfy, in full or in part, with environmental credits.

Accounting for environmental credits

Entities may purchase, receive, be granted or internally generate environmental credits and use them for voluntary purposes (e.g., in support of their climate commitments), to settle liabilities associated with compliance programs or to sell or trade.

An entity would be required to evaluate the planned use of an environmental credit on the date it is obtained. It would recognize an asset if it is probable the environmental credit will be used by the entity to settle an environmental credit obligation or separately transferred in an exchange transaction (i.e., sold or traded). The cost of all other environmental credits, including those acquired for voluntary purposes, would be expensed as incurred.

Environmental credits would generally be initially measured at cost, including any associated transaction costs. The initial measurement of a credit internally generated by the entity or obtained through a grant from a regulator or its designees would be limited to any transaction costs incurred. Transaction costs include costs necessary to validate, register or authenticate an environmental credit.

An entity would reassess its planned use of each environmental credit recognized as an asset at the end of each reporting period. Environmental credits that are probable of being used to settle an environmental credit obligation would generally not have to be tested for impairment. All other recognized environmental credits would be tested for impairment at the end of each reporting period. Additionally, environmental credits that are no longer probable of being used to settle an environmental credit obligation or separately transferred in an exchange transaction would be derecognized. Subsequent recognition would be prohibited.

The proposal would permit the use of a portfolio approach for sufficiently similar environmental credits. An entity would need to subsequently measure similar environmental credits recognized as assets using one of the following costing methods: average cost; first-in, first-out; or specific identification. While environmental credits recognized as assets are generally subsequently measured at cost, an entity would be able to make an accounting policy election to account for a class of eligible noncompliance environmental credits at fair value, with any remeasurement gain or loss included in net income.

Accounting for environmental credit obligations

An entity would have to recognize a liability when events occurring on or before the reporting date result in an environmental credit obligation. For example, if a utility is required to remit one REC for every 10 megawatt-hours of electricity delivered to customers and has delivered 1,000 megawatt-hours of electricity on or before the reporting date, the entity would recognize an environmental credit obligation liability for the obligation to remit 100 RECs.

The measurement of an environmental credit obligation would generally be based on the carrying amount of environmental credits owned at the balance sheet date that are considered probable of being used to settle an environmental credit obligation. If an entity does not own sufficient credits to satisfy the obligation, the excess obligation would be measured based on the fair value of the credits necessary to settle that portion of the liability at the reporting date, unless the entity intends to settle the obligation in cash or with credits for which the entity has an unconditional right to receive for a fixed price, as consideration in a contract or as part of a compliance program.

Presentation and disclosure

The proposed amendments would prohibit an entity from offsetting environmental credit assets and environmental credit obligation liabilities on the balance sheet. Entities would be required to provide qualitative disclosures about their environmental credits, including costing methods used, and environmental credit programs that give rise to an obligation. They would also be required to make the following quantitative disclosures:

- ▶ A description and carrying amount for each significant environmental credit asset holding and each significant environmental credit obligation liability (interim and annual)
- ▶ Revenues or gains from sales of environmental credits and the carrying amount of the credits at the date of sale (interim and annual)
- ▶ Cash paid for environmental credits (interim and annual)
- ▶ Total expense recognized for environmental credit obligations, disaggregated by accruals for emissions during the reporting period and remeasurement of liabilities that were previously recognized

How we see it

While the proposed amendments would eliminate the need for analogies to other guidance and reduce diversity in practice, they could result in many entities changing practice (e.g., no longer netting the environmental credit and environmental credit obligation).

Effective date and transition

The FASB said it would determine an effective date after it receives feedback on the proposal.

Entities would be required to adopt the amendments using a modified retrospective approach, based on the planned use of any environmental credits held at the date of initial application, by recognizing a cumulative effect adjustment to retained earnings at the date of initial application (i.e., prior reporting periods would not be recast). The proposed transition provisions include several requirements intended to reduce the cost and complexity of adopting the amendments as though they had always been applied.

Endnotes:

- ¹ Proposed Accounting Standard Update, *Accounting for Environmental Credit Programs*.
- ² Refer to sections 2.5.1.3 and 2.5.1.4 of our Financial reporting developments publication on income taxes.

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