

# To the Point

FASB – final guidance

## FASB issues guidance on accounting for environmental credits and environmental credit obligations

The guidance applies to all entities that buy, receive or internally generate environmental credits.

### What you need to know

- ▶ The FASB issued final guidance for the recognition, measurement, presentation and disclosure of environmental credits and environmental credit obligations.
- ▶ Entities are required to capitalize or expense an environmental credit based on its planned use. Environmental credits probable of being sold, distributed or used to settle an environmental credit obligation are recognized as an asset. The cost of all other environmental credits, including those used for voluntary purposes, are recognized as an expense.
- ▶ Entities are required to recognize a liability when events occurring on or before the reporting date result in an environmental credit obligation.
- ▶ The guidance is effective for fiscal years beginning after 15 December 2027, including interim periods within those years, for public business entities and a year later for all other entities. Early adoption is permitted.
- ▶ Entities are required to adopt the amendments on a retrospective basis by recognizing a cumulative effect adjustment to retained earnings at the date of initial application (i.e., prior reporting periods will not be recast).

### Overview

The Financial Accounting Standards Board (FASB or Board) **issued** final guidance<sup>1</sup> establishing requirements on how to recognize, measure, present and disclose environmental credits and certain related obligations that can be settled with environmental credits.

The standard applies to all entities that buy, receive or internally generate environmental credits they intend to sell, trade or distribute. It also applies to entities that use such credits for compliance or voluntary purposes (e.g., for use in carbon-neutral or net-zero initiatives).

The guidance specifies when an entity is required to recognize an environmental credit as an asset or an expense and, if the environmental credit is recognized as an asset, how the entity measures it. The guidance also specifies when an entity is required to recognize an environmental credit obligation (ECO) liability related to environmental compliance programs and how those liabilities are measured. Entities are required to present environmental credits and ECO liabilities on a gross basis and to provide certain annual disclosures about those amounts.

The guidance addresses stakeholder feedback that US GAAP did not specifically address how to recognize and measure environmental credits or the related obligations, leading to diversity in practice. For example, under legacy US GAAP, some entities account for environmental credits by directly expensing them or by recognizing them by analogy to Accounting Standards Codification (ASC) 330, *Inventory*, and ASC 350-30, *Intangibles – Goodwill and Other – General Intangibles Other Than Goodwill*.

## Key considerations

### Scope

#### *Environmental credits*

The guidance applies to all environmental credits. An environmental credit is 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, or previously was, separately transferable in an exchange transaction. If an item is no longer separately transferable in an exchange transaction, an entity must be able to use it to satisfy an ECO to meet this criterion.
- ▶ 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.

Carbon offsets, renewable energy certificates (RECs), cap and trade allowances, emission allowances, and other industry-specific credits, such as renewable identification numbers (RINs), generally meet the definition of an environmental credit.

### How we see it

Because income tax credits are excluded from the definition of an environmental credit, entities should continue to account for renewable energy tax credits, including those associated with the Inflation Reduction Act, in accordance with other US GAAP. See sections 2.5.1.3 and 2.5.1.4 of our Financial reporting developments publication, *Income Taxes*, for further discussion of accounting for tax credits.

Environmental credits that are not probable of being used to settle an ECO or separately transferred in an exchange or nonreciprocal transaction are expensed.

### ***Environmental credit obligations***

The guidance applies to all ECOs. An ECO is 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.” The definition excludes obligations in the scope of ASC 410-30, *Asset Retirement and Environmental Obligations – Environmental Obligations*.

The FASB noted in paragraph BC6 of the ASU’s Background Information and Basis for Conclusions that this definition is intended to capture common regulatory compliance programs, including cap and trade programs, renewable portfolio standard (RPS) programs and renewable fuel standard (RFS) programs. The definition does 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 is required to evaluate the planned use of an environmental credit on the date it is obtained. It recognizes an asset if it is probable that the credit will be used by the entity to settle an ECO or separately transferred in an exchange or nonreciprocal transaction (e.g., sold, traded, distributed to investors). The cost of all other environmental credits, including those acquired for voluntary purposes, is expensed as incurred.

Recognized environmental credits are generally 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 is limited to any transaction costs incurred.

An entity reassesses its planned use of each environmental credit recognized at the end of each reporting period. Environmental credits that continue to be probable of being used to settle an ECO (i.e., compliance environmental credits) are generally not tested for impairment. All other recognized environmental credits (i.e., noncompliance environmental credits) are tested for impairment and measured at cost less impairment, if any, at the end of each reporting period (unless the fair value measurement policy election is made).

Additionally, an entity derecognizes environmental credits that are no longer probable of being used to settle an ECO or separately transferred in an exchange or nonreciprocal transaction. Subsequent recognition is prohibited.

An entity subsequently measures similar recognized environmental credits using one of the following costing methods: average cost; first-in, first-out; or specific identification. While recognized environmental credits are generally subsequently measured at cost, an entity can 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 recognizes a liability when events occurring on or before the reporting date result in an ECO. 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 ECO liability for the obligation to remit 100 RECs.

The measurement of an ECO liability is generally based on the carrying amount of environmental credits owned at the balance sheet date that are considered probable of being used to settle an ECO (funded portion). If an entity does not own sufficient credits to satisfy the obligation (unfunded portion), the excess obligation is generally measured based on the fair value of the credits necessary to settle that portion of the liability at the reporting date.

## Presentation and disclosure

The guidance prohibits an entity from offsetting environmental credit assets and ECO liabilities on the balance sheet. Entities are required to provide several quantitative and qualitative disclosures about their environmental credits and ECOs in annual reporting periods.

## How we see it

The new guidance eliminates the need to apply other US GAAP by analogy to account for environmental credits and ECOs. Entities may need to update their processes (e.g., measurement of environmental credits, gross presentation of environmental credits and ECO liabilities) to comply with the new requirements.

## Effective date and transition

The guidance is effective for public business entities for fiscal years beginning after 15 December 2027, including the interim periods within those years. It is effective for all other entities for fiscal years beginning after 15 December 2028, including the interim periods within those years. Early adoption is permitted.

Entities are required to adopt the amendments on a retrospective basis by recognizing a cumulative effect adjustment to retained earnings at the date of initial application (i.e., prior reporting periods will not be recast). The transition provisions include several requirements intended to reduce the cost and complexity of adopting the amendments as though they had always been applied.

## Endnotes:

<sup>1</sup> Accounting Standards Update (ASU) 2026-02 – Environmental Credits and Environmental Credit Obligations (Topic 818).

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