KPMG

FASB proposal

Environmental credits and environmental credit obligations

December 18, 2024

FASB proposes guidance for environmental credits and obligations to improve transparency and comparability.

Source and applicability

- Proposed ASU, Environmental Credits and Environmental Credit Obligations
- Entities that have environmental credits or have environmental credit obligations (ECOs).

Fast facts, impacts, actions

The accounting for environmental credits has been on the radar of standard-setters for decades, yet there are currently no US GAAP requirements. Practice is diverse as entities analogize to guidance on inventory, intangible assets or even marketing costs to account for environmental credits. Further, there is inconsistency in how ECO liabilities are recognized and measured.

To address this diversity, the FASB's proposed ASU would create Topic 818 to account for environmental credits and ECOs. The proposal would do the following:

- Define attributes of environmental credits and ECOs and limit Topic 818's scope to credits and obligations meeting these definitions.
- Require environmental credits to be accounted for based on how an entity intends to use the credit:
  - Environmental credits that are probable of being used to settle an ECO or transferred in an exchange transaction would be recognized as an asset.
  - The cost of all other environmental credits would be expensed as incurred.
- Require environmental credits that are probable of being used to settle an ECO (compliance credits) to be recognized at cost with no subsequent remeasurement, and all other environmental credits recognized as assets (noncompliance credits) to also be recognized at cost but be tested for impairment at each reporting date.
- Require entities to recognize ECO liabilities based on the amount of credits needed to satisfy the obligation as if the reporting date were the end of the compliance period. A liability would be measured based on the carrying amount of compliance credits on hand (the funded portion). Any unfunded portion would generally be measured based on the fair value of credits the entity would need to purchase to satisfy the obligation.

Comment letter feedback is due on April 15, 2025.

Background

Emissions trading arrangements are not new, but for entities making net-zero or other emissions commitments, offsets and credits are often a key driver of their strategy. These arrangements were historically established to help entities comply with governmental or regulatory emissions mandates. Now they are also a catalyst of growth and innovation, incentivizing entities to develop and implement the latest renewable technology. These growing and largely self-imposed strategic commitments have caused the related accounting issues to reemerge as a high priority.

A growing number of global programs incentivize entities to produce cleaner products and invest in renewable energy projects. Entities generally obtain or generate environmental credits through regulators or designees by producing environmentally friendly products or meeting and exceeding emissions standards in their production processes. For instance, automobile manufacturers can earn credits by producing electric vehicles, which they can use to fulfill compliance obligations or trade with other manufacturers. Entities across all sectors can invest in renewable energy projects that generate Renewable Energy Certificates (RECs), which they can use to offset their own emissions or sell.

In the US, federal and state mandatory compliance programs include cap-and-trade type programs such as those created by California's Low Carbon Fuel Standard (LCFS), and trading programs related to the Clean Water Act (CWA) and Clean Air Act (CAA). These programs often establish markets in which entities can purchase environmental credits to meet their compliance obligations and sell excess credits. Proponents believe that environmental credits provide entities with a means to achieve sustainability goals and create enterprise value. However, the expansion of these programs in the US introduces accounting complexity as they become more sophisticated to meet stakeholders' growing environmental and financial expectations.

There are currently no accounting requirements under US GAAP specific to carbon offsets, allowances or credits. Consequently, practice has become diverse as entities analogize to guidance on inventory, intangible assets or even marketing costs to account for environmental credits. Further, there is inconsistency in how ECOs are recognized and measured. The proposed ASU would address this diversity by establishing new Topic 818.

The Emerging Issues Task Force attempted to establish guidance in 2003 with Issue no. 03-14, *Participants' Accounting for Emissions Allowances under a "Cap and Trade" Program*. However, it never finalized this Issue and entities seek to interpret and apply current accounting guidance to arrangements that are often complex and evolving.

Scope of Topic 818

Topic 818 would encompass accounting for the acquisition or generation of environmental credits and ECOs. Specifically, its scope would apply to credits and obligations that meet the following definitions.

Environmental credit	An enforceable right that is acquired, internally generated, granted by a regulatory agency or designee(s), or received in a nonreciprocal transfer that is not a grant from a regulator, and that meets the following criteria: • lacks physical substance and is not a financial asset; • is represented to prevent, control, reduce or remove emissions or other pollution; • is separately transferable in an exchange transaction; and • is not an income tax credit.

ECO liability	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. Obligations in the scope of Subtopic 410-30 are not ECOs.

The proposed update also indicates that environmental credits and ECO liabilities accounted for under Topic 818 would not be in the scope of Topic 815 on derivatives.

If a credit does not meet the criteria to be in scope because it is not transferable, the FASB has indicated it expects the cost of the credit to be expensed as incurred. Further, income tax credits are not in scope of Topic 818; an entity would have to consider whether Topic 740 or other US GAAP applies.

Accounting model: Environmental credits

The proposed update would introduce intent-based asset recognition and measurement models for environmental credits. That is, how an entity expects to use or consume an environmental credit would determine the appropriate accounting model. To identify the appropriate accounting model, an entity would first assess whether it is *probable*, collectively, that it will use its environmental credits to either settle an ECO liability or transfer them in an exchange transaction:

- If the environmental credits meet the probability threshold then they are recognized as assets and measured at cost. Subsequent measurement would differ based on whether they are classified as compliance or noncompliance credits.
- If the probability threshold is not met, the cost of the credits (referred to as *all other credits*) would be expensed as incurred.

The assessment of the nature of the asset is evaluated each period and the credit could be reclassified from a compliance credit to a noncompliance credit when intentions shift. However, once costs are expensed that expense may not be later reversed even if the related credit subsequently become a compliance or noncompliance credit.

The following table summarizes the recognition and measurement criteria.

Compliance credits	Noncompliance credits	All other credits
Recognition		
Recognized as assets if it is probable that they will be used to settle an ECO liability or be transferred in an exchange transaction. For example, an asset would be recorded if it is 50% likely it will be used to settle an ECO and 50% likely it would be transferred in an exchange transaction because the collective likelihood of one of those events occurring is probable.		Expense costs as incurred.
Initial measurement		
Measured at cost. Capitalizable costs related to granted and internally generated credits are limited to transaction costs incurred (e.g. application fees) and could be zero. Other acquired credits would consider the guidance in Subtopic 805-50 on asset acquisitions to determine cost unless subject to other GAAP.		

<table>
<tr><th>Compliance credits</th><th>Noncompliance credits</th><th>All other credits</th></tr>
<tr><td colspan="3">Classification</td></tr>
<tr><td>Classified as compliance credits if it is probable they will be used to settle an ECO.</td><td>All other environmental credits recognized as assets are classified as noncompliance credits.</td><td></td></tr>
<tr><td colspan="3">Subsequent measurement</td></tr>
<tr><td>At cost.
Not tested for impairment.</td><td>At cost or fair value, if eligible (see other considerations below).
Tested for impairment at each reporting date. An impairment loss occurs when the carrying value of a noncompliance credit exceeds its fair value.</td><td></td></tr>
<tr><td colspan="2">These assets are not amortized.</td><td></td></tr>
<tr><td colspan="3">Derecognition</td></tr>
<tr><td colspan="2">Apply Subtopic 610-20 unless in the scope of other guidance such as Topic 606 on revenue from contracts with customers.</td><td></td></tr>
</table>

The proposal specifies that that an entity would consider guidance on recognition and measurement (e.g. asset acquisition guidance) or on disposal (e.g. Subtopic 610-20 or Topic 606). However, it does not provide any specific guidance on how to allocate costs on acquisition in complex arrangements or specific guidance on derecognition, so an entity will need to evaluate the principles of these standards to determine the appropriate accounting.

Other considerations

The proposal provides flexibility on how an entity would practically apply the requirements. An entity that subsequently measures its credits at cost would choose between the specific identification, FIFO or average cost costing methods for similar environmental credits. Further, an entity could use a portfolio approach to subsequently measure sufficiently similar environmental credits, regardless of the costing method used. 'Sufficiently similar' would be determined when it is unlikely at the reporting date that a significant loss would arise from derecognizing an individual credit from the portfolio. This determination would be quantitative, qualitative or both, depending on facts and circumstances.

An entity can elect an accounting policy to remeasure a class (e.g. RECs, RINs) of noncompliance credits to fair value at each reporting period until they are derecognized. However, noncompliance credits granted by a regulator or internally generated would not be eligible to be remeasured to fair value.

Because the model for credits can change based on changes in intent, entities would need a robust system to track significant information about environmental credits and processes and controls over the initial and subsequent re-evaluations.

Accounting model: Environmental credit obligations

At each reporting date an entity would determine whether to recognize an ECO liability. To make this determination, the entity would calculate the amount it would owe at the balance sheet date as if that date was the end of the compliance period. This calculation would disregard expected future actions or activities that could reduce the number of environmental credits due at the compliance program's settlement date.

The liability's measurement would depend on whether the liability is considered funded or unfunded. The 'funded' portion of the liability consists of amounts that could be settled in on-hand compliance credits. When the entity does not have sufficient compliance credits on hand at the reporting date, that excess required is considered the 'unfunded' portion. The follow table summarizes the proposed measurement requirements for an ECO liability.

Funded	Based on the carrying amount of compliance credits owned by an entity using its best estimate of the credits to be derecognized on settlement.
Unfunded	Using the fair value at the reporting date of the environmental credits an entity would need to acquire to settle that portion of the liability unless the entity intends to settle (or partially settle) by remitting: • Cash. The entity would measure the liability based on the cash settlement amount under the compliance program. • Environmental credits that will be received before the settlement of the liability from either (1) an existing unconditional purchase commitment for a fixed quantity of environmental credits at a fixed price or (2) an unconditional right to receive a fixed quantity of environmental credits as part of a compliance program or contract for which environmental credits will be received as consideration. The entity would measure the liability based on the estimated cost basis of the environmental credits to be received.

When the entity recognizes an ECO liability, it typically recognizes a corresponding expense and recognizes subsequent changes in the liability through earnings in the same line item as the initial measurement of the ECO liability. However, if under a compliance scheme an entity is required to remit a fixed number of environmental credits to a regulator solely because it is existing as a business (not based on its activities or events), the entity would:

- recognize an ECO liability on the date that it becomes obligated to remit the credits; and
- recognize an asset (akin to a prepaid fee) to be amortized over the compliance period. This asset is separate from the environmental credits that the entity would use to satisfy the ECO liability.

ECO liabilities would be derecognized under existing guidance for extinguishment of liabilities.

The measurement of an ECO liability is based on the entity's accounting for environmental credits. Therefore, an entity would first account for the compliance credits on hand which is used to measure the funded portion of its liability. If the compliance credits were internally generated and therefore have little or no cost basis, the funded portion of the liability could be zero or a nominal amount.

Presentation

The compliance credits and ECO liabilities would be presented gross and offsetting would be prohibited. The compliance and noncompliance credits that would be transferred or remitted within 12 months of the balance sheet date would be classified as current and the remainder would be noncurrent. The portion of the ECO liability that would be settled within 12 months of the balance sheet date would be classified as current and the remainder would be noncurrent.

Disclosure

Topic 818 would include quantitative and qualitative disclosure requirements about the entity's environmental credits and ECOs. The following table summarizes key proposed disclosures.

Environmental credits
Annual
Qualitative information about how the entity obtains, uses or intends to use environmental credits, its subsequent measurement methodology, and significant estimates and judgments.
Interim and annual
For environmental credit asset holdings: • a description of each significant asset holding, its carrying amount and classification; • the aggregate carrying amount of individually insignificant environmental credits.
The current and noncurrent portion of compliance and noncompliance credits, if not presented separately on the balance sheet.
Fair value disclosures in Topic 820 for environmental credits remeasured to fair value.
For purchases or sales of environmental credits during the period: • quantitative information about revenue and gains and losses from sales, including from credits that were never recognized as assets or derecognized in a prior period; • cash paid for credits during the period.
Environmental credit obligations
Annual
Qualitative information about compliance programs, including about activities or events that result in ECO liabilities, types of environmental credits accepted, the nature and timing of settlement provisions, significant estimates and judgments, and how the unfunded portion of an ECO liability is measured.
Interim and annual
• a description of each significant obligation, including the compliance program and jurisdiction and its carrying amount, disaggregated by funded/unfunded; • the aggregate carrying amount of individually insignificant ECO liabilities.
The current and noncurrent funded and unfunded ECO liability, if not presented separately on the balance sheet.
Fair value disclosures in Topic 820 applicable for the unfunded portion of the ECO liability measured at fair value.
Total expense recognized disaggregated between accruals for emissions occurring during the reporting period and remeasurement of ECO liabilities previously recognized.
Total amortization expense recognized related to assets recognized when an entity has an ECO solely because it is existing as a business.

Effective date and transition

Topic 818's effective date will be determined after FASB considers stakeholder feedback, but tentatively early adoption would be permitted.

The proposal would require a modified retrospective transition approach with a cumulative-effect adjustment to opening retained earnings in the period of adoption. Prior periods would not be recast.

Compliance credits would be measured at their carrying amount immediately before initial application, while noncompliance credits would be measured at the lesser of their historical carryover basis and fair value. An entity would be permitted to continue to include costs of credits that were capitalized as part of another asset (e.g. inventory) before application. All other credits no longer recognized as assets would be derecognized with an offsetting adjustment to retained earnings.

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