BDO BULLETIN

ENVIRONMENTAL CREDIT PROGRAMS (FASB PROPOSAL)

DECEMBER 2024

SUMMARY

The Financial Accounting Standards Board (FASB) recently issued a proposed accounting standards update on an entity's accounting for environmental credits (ECs) and obligations in its financial statements in accordance with U.S. GAAP. *Environmental Credits and Environmental Credit Obligations (Topic 818)* proposes guidance on the recognition, measurement, presentation, and disclosure requirements for ECs and EC obligation (ECO) liabilities. Comment letters are due by April 15, 2025.

BACKGROUND

Environmental credits, such as for carbon and renewable energy, are becoming an increasingly important part of efforts to promote sustainability. An entity may hold environmental credits to:

- Meet a regulatory obligation
- Be sold or traded in an exchange
- Meet voluntary environmental, social, and governance (ESG) goals.

An entity may obtain environmental credits in many ways, including by grant or allocation from regulators, by acquisition, or by producing the credit itself.

The lack of specific accounting guidance in U.S. GAAP has led to diverse practices. If the environmental credit meets the definition of an asset,[1] entities commonly apply the two accounting models shown in the table.

[1] The definition in *FASB Concepts Statements No. 8, Conceptual Framework for Financial Reporting*, Chapter 4, includes the requirement that the credit represent a present right to an economic benefit.

CLASSIFICATION	INITIAL RECOGNITION	SUBSEQUENT ACCOUNTING
Inventory (ASC 330)	Recognize at cost	▶ Expense when used (retired) ▶ Diversity in practice exists for subsequent measurement (lower of cost or market)
Intangible Asset (ASC 350)	Recognize at cost	▶ Expense when used (retired) ▶ Diversity in practice exists for amortization ▶ Diversity in practice exists when evaluating impairment

Today, entities subject to regulatory requirements often recognize liabilities in accordance with ASC 450, *Contingencies*. However, diversity in practice also exists for measurement and presentation:

- Net presentation — Some entities recognize an obligation for the excess of total emissions over their environmental credit assets
- Gross presentation — Other entities recognize an obligation for their total emissions (in addition to an asset for environmental credit assets)

In response to the diversity in practice, the FASB began developing EC accounting standards to enhance transparency, comparability, and reliability in financial statements.

ENVIRONMENTAL CREDIT ASSETS

Scope

To meet the definition of an environmental credit asset under U.S. GAAP (and be within the scope of the proposed guidance), the item must be an enforceable right that is acquired, internally generated, granted by a regulatory agency or its designee(s), or received in a nonreciprocal transfer that is not a grant from a regulatory agency or its designee(s). It also must meet **all** 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 forms of pollution
- It can be separately transferred in an exchange transaction
- It is not an income tax credit and cannot be used to reduce income taxes.

ITEMS THAT DO NOT MEET THE PROPOSED DEFINITION OF ENVIRONMENTAL CREDITS

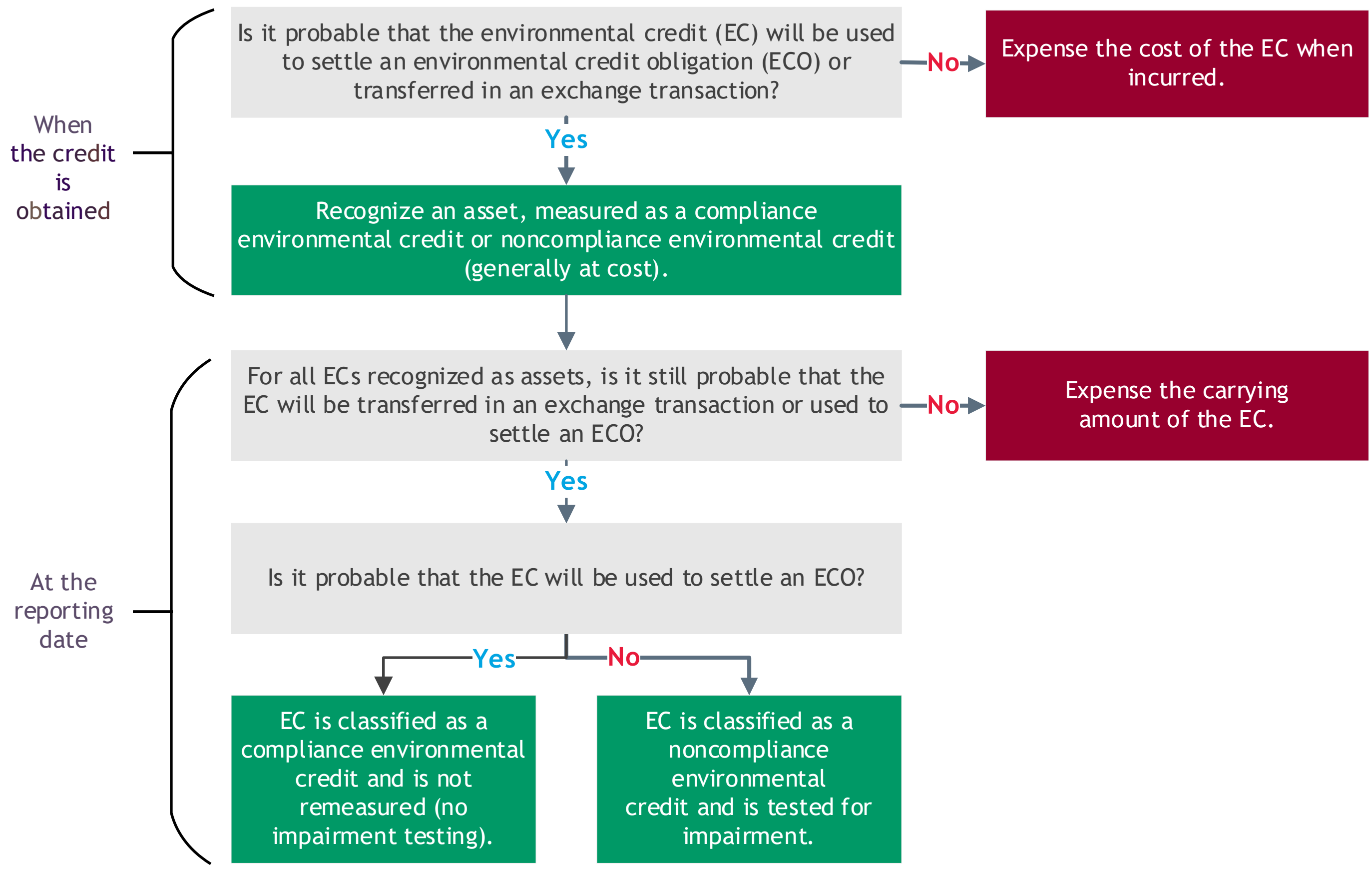
The following items are excluded from the scope of the proposed guidance:

- Renewable clean energy tax credits (includes transferable and refundable tax credits)
- Additional payments made for carbon neutral activities
- Investments in partnerships or other credit-generating equity structures

An entity would need to apply other U.S. GAAP (for example, ASC 740, *Income Taxes*) to account for such items.

Flowchart for Environmental Credit Assets

The flowchart summarizes the accounting for an environmental credit asset, if an entity has not elected to remeasure noncompliance environmental credits at fair value each reporting period.



Recognition of Environmental Credit Assets

Once an entity determines that the item meets the U.S. GAAP definition of an environmental credit, its intent dictates whether it recognizes the credit. As discussed above, an entity may obtain environmental credits to:

- Comply with a law or regulation that requires it to settle an ECO liability (compliance environmental credits)
- Sell or trade (referred to as "noncompliance environmental credits," even if the credits can be used to settle a compliance obligation)
- Meet voluntary ESG goals (voluntary environmental credits)

Even if the item meets the proposed definition of an environmental credit asset, an entity would recognize an environmental credit as an asset **only** when it is **probable** it will use the credit to either:

- Settle an ECO liability
- Be sold or traded in an exchange transaction

All other environmental credits (that is, voluntary environmental credits the entity intends to use to meet ESG goals) are expensed when incurred.

BDO INSIGHTS — INTENT-BASED STANDARD

The environmental credit asset model is an intent-based standard, which may result in a different accounting treatment for the same (or similar) environmental credits based on an entity's intended use.

For example, if Entity A holds an environmental credit for sale or trade, it would recognize the noncompliance environmental credit as an asset. However, if Entity A sells that credit to Entity B, which intends to use the credit to meet its voluntary ESG goals, Entity B must expense the cost of acquiring that credit.

Furthermore, only costs of compliance environmental credits and noncompliance environmental credits that meet the probability threshold can be capitalized as part of the cost of another asset, if allowed in accordance with other U.S. GAAP. An entity may **not** capitalize the cost of any voluntary environmental credits as part of the cost of another asset.

Initial Measurement of Environmental Credit Assets

The FASB proposed that an entity generally will measure an environmental credit asset at cost in accordance with the asset acquisition guidance in ASC 805-50, *Business Combinations — Related Issues*, unless it was acquired as part of a transaction within the scope of other U.S. GAAP or received in a nonreciprocal transfer that is not a grant from a regulator or its designee(s).

However, if the environmental credit is internally generated or obtained through a government grant from regulators or its designees, an entity measures the credit using the transaction costs incurred to obtain the environmental credit, if any. Transaction costs include only those costs necessary to validate, register, or authenticate an environmental credit so that the environmental credit may be separately transferred in an exchange transaction or used to settle an environmental credit obligation. Under the proposal, an entity may not capitalize other costs related to internally generated credits.

Subsequent Measurement of Environmental Credit Assets

At each reporting period, an entity would reassess whether it is **probable** that it will use the environmental credit to:

- Settle an ECO liability
- Be sold or traded in an exchange transaction

As shown in the flowchart above, an entity would subsequently account for environmental credits based on its intent. Both compliance credits and noncompliance credits would be measured at cost. However, compliance credits would not be tested for impairment, whereas noncompliance credits would be tested for impairment at each reporting date. An impairment is recognized when a noncompliance credit's carrying amount exceeds its fair value. An entity may not subsequently reverse an impairment.

If upon reassessment the entity determines that a compliance environmental credit requires reclassification to a noncompliance credit (or vice versa), it must test the credit for impairment before applying the applicable subsequent measurement guidance. An entity generally cannot amortize an environmental credit.

DEVELOP PROCESSES AND CONTROLS FOR RECOGNITION AND MEASUREMENT

Given the intent-based model for environmental credits, entities will need to design processes and controls over their recognition and measurement, which will require coordinating with others that manage the acquisition and use of environmental credits. Entities must also design controls for testing noncompliance environmental credits for impairment each reporting period.

Other Accounting Guidance for Environmental Credit Assets

The proposal also includes guidance on:

- Derecognition in exchange transactions
- Costing methods (first-in, first-out; specific identification; or average cost)
- Portfolio approach
- Fair value option for eligible noncompliance environmental credits

ENVIRONMENTAL CREDIT LIABILITIES

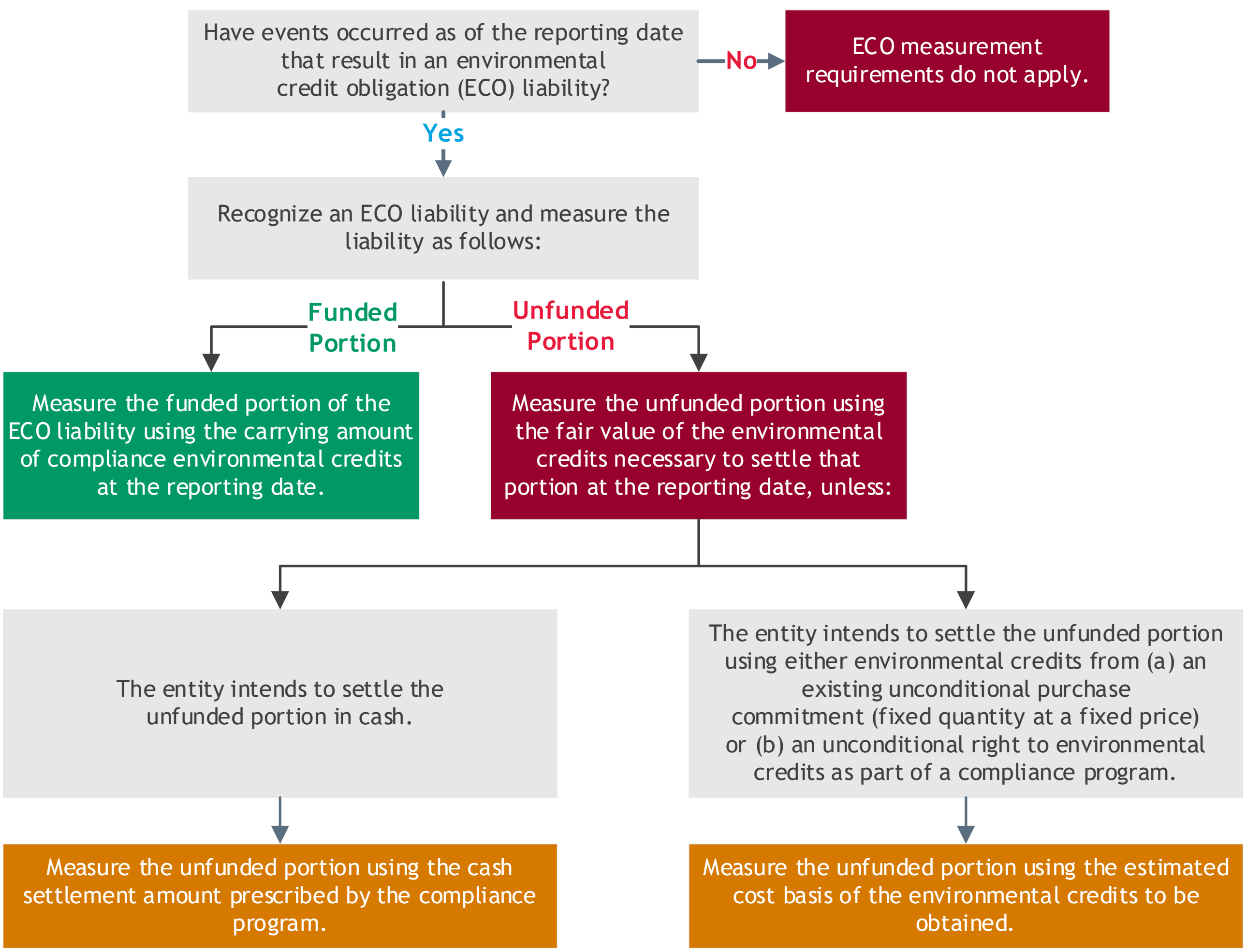
Scope

The proposal defines an ECO liability as an obligation that **both**:

- Arises from laws, statutes, or ordinances represent ed to prevent, control, reduce, or remove emissions or other forms of pollution
- May be settled with environmental credits

Flowchart for Environmental Credit Liabilities

The flowchart summarizes the accounting for an environmental credit liability.



The proposal **prohibits** an entity from measuring liabilities at fair value under ASC 825, *Financial Instruments*.

Recognition of ECO Liabilities

An entity recognizes an ECO liability when an obligation exists, determined as if the balance sheet date was the end of the compliance period.

Initial and Subsequent Measurement of ECO Liabilities

An ECO liability's initial and subsequent measurement depends on how much is funded and unfunded, as shown in the table.

ECO LIABILITY	INITIAL AND SUBSEQUENT MEASUREMENT
Funded ECO liabilities	Measure at the carrying amount of the compliance environmental credits that will be used to settle the ECO liability at the balance sheet date.
Unfunded ECO liabilities that will be remitted in cash to a regulator	Measure at the cash settlement amount.
Unfunded ECO liabilities that will be settled through an unconditional purchase commitment for a fixed quantity of ECs at a fixed price or 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	Measure using the estimated cost of the credits the entity will obtain through the commitment.
All other unfunded ECO liabilities	Measure at fair value in accordance with ASC 820, *Fair Value Measurement*.

An entity will remeasure the liability at each balance sheet date (after remeasuring any environmental credit assets, if applicable) and recognize any changes to the liability in earnings. Entities will derecognize the ECO liability in accordance with ASC 405-20, *Liabilities — Extinguishments of Liabilities* with gains or losses recognized in the same line item as the initial measurement of the ECO liability.

PRESENTATION

The proposal includes guidance on presentation in the balance sheet, income statement, and cash flow statement. Notably, it requires gross presentation and would not allow entities to offset ECO liabilities with environmental credit assets. Environmental credit assets and obligations would be classified (if an entity presents a classified balance sheet) based on the entity's expectation of when it will use the asset or settle the obligation.

DISCLOSURES

The proposal would require entities to make quantitative and qualitative disclosures about their involvement in environmental credit programs, the types of credits owned, and the activities that gave rise to the ECO liabilities. Entities must also provide information about their accounting policies. Additional disclosures would be required for significant environmental credit assets and liabilities, revenues, gains, expenses (including impairments), and fair value measurements.

TRANSITION AND NEXT STEPS

The FASB proposed a modified retrospective approach as of the beginning of the annual period of adoption, with early adoption allowed. The FASB will determine the effective date and next steps after receiving feedback from the comment letter process.

DEVELOP PROCESSES AND CONTROLS OVER ENVIRONMENTAL CREDIT ASSETS AND OBLIGATIONS

As discussed above, to comply with the proposal, an entity would need to implement controls that document:

- The entity's intent for using environmental credits
- When the entity expects to sell, trade, or remit environmental credits
- When the entity expects to settle an ECO liability

That process may require coordinating with personnel outside the accounting function. Management may want to consider revising their processes now to ease transition if the proposed guidance is finalized.

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Link to Proposed Accounting Standards Update

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