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# FASB Releases Proposed ASU on the Accounting for Environmental Credit Programs

## Overview

On December 17, 2024, the FASB released a [proposed ASU](#)<sup>1</sup> as part of its project (added to the Board's technical agenda in May 2022) on the accounting for environmental credit programs. Comments on the proposal are due by April 15, 2025.

The objective of the FASB's project on environmental credit programs is to improve the recognition, measurement, presentation, and disclosure requirements related to (1) environmental credits and, when applicable, (2) compliance obligations that may be settled with environmental credits. Currently, the treatment of such credits and liabilities is not explicitly addressed in U.S. GAAP.

The guidance in the proposed ASU is expected to have broad impacts given the number of companies with operations subject to emission regulations and that acquire environmental credits to achieve internal targets related to carbon footprint initiatives. An entity's accounting under the proposed standard is based on its determinations of the expected use of the credits. Determinations of whether the credit will be used for compliance, exchange, or voluntary purposes can change over the life of the credit, and changes in management's intent will affect subsequent measurement of the credits. If the standard is issued as proposed, companies will want to have strong processes and controls related to establishing intent, given the risk that subsequent changes in intent affect subsequent measurement.

<sup>1</sup> FASB Proposed Accounting Standards Update (ASU), *Environmental Credits and Environmental Credit Obligations (Topic 818)*.

The key provisions of the proposed ASU are discussed below. In addition, the decision trees in the appendixes of this *Heads Up* reflect the proposed guidance on environmental credits and environmental credit obligations (ECOs) and may be used to determine the appropriate accounting under the proposal.

## Scope

### Environmental Credit Assets

For an environmental credit to be within the proposal's scope, it must:

- Be enforceable.
- Be separately transferable in an exchange transaction.
- Lack physical substance and not meet the definition of a financial asset under U.S. GAAP.
- Be intended to prevent, control, reduce, or remove emissions or other pollution.
- Not be 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.

In addition, credits may:

- Take many forms (e.g., credits, certificates, allowances, and offsets).
- Include those from related parties.
- Be acquired, granted by a regulatory agency (including those in return for performance), or internally generated.

On the basis of the above criteria, we would expect items such as the following to be subject to the proposed guidance:

- Carbon offsets.
- Emission allowances.
- Renewable energy certificates.
- Renewable identification numbers.
- Corporate average fuel economy (CAFE) credits.

### Environmental Credit Obligations

The proposed ASU applies to ECOs, which are obligations that arise 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 that are within the scope of ASC 410-30<sup>2</sup> are not ECOs.



#### Connecting the Dots

An entity's commitment to achieve certain climate goals or targets does not, in itself, meet the definition of an ECO. We believe that, in a manner consistent with the principles discussed by a FASB staff member at the Board's May 25, 2022, meeting, when an entity obtains and uses credits solely as a result of self-imposed goals or targets, a liability may not exist, since an "obligation of an entity to itself cannot be a liability," as indicated in paragraph E43 of FASB Concepts Statement 8, Chapter 4.

<sup>2</sup> For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification.](#)"

Thus, depending on the facts and circumstances, a voluntary program (e.g., one in which an entity makes a public statement about its commitment to achieving a climate goal that is not part of a required compliance program) will generally not result in the need to record a liability because there is no external obligation (e.g., contractual or legal).

## **Recognition**

### ***Asset Recognition***

Only credits that it is probable the company will use (e.g., sell to a third party or remit in satisfaction of a compliance obligation) are eligible for recognition.

Under the proposal, an entity would be prohibited from capitalizing the cost of environmental credits that will not be sold or used to settle an ECO liability (e.g., credits that will be voluntarily retired), including as part of another asset such as inventory or prepaid assets.

The proposal also indicates that an expense would be recognized for “a nonrefundable deposit made to obtain an environmental credit for which it is not probable that the entity will use the environmental credit to settle an environmental credit obligation or transfer it in an exchange transaction.” This proposed guidance reflects the FASB’s view that a credit acquired for voluntary purposes is akin to an asset that a company chooses to abandon. The company will not realize future value from the asset and therefore should not capitalize the associated cost on the balance sheet.

In addition, the proposed ASU contains examples illustrating application of the recognition guidance to environmental credits.

### ***ECO Recognition***

The proposal indicates that, in a manner consistent with the definition of a liability, an ECO should be recognized when activities or events occurring on or before a balance sheet date indicate that an ECO exists.

The timing of the recognition of an ECO depends on the underlying environmental credit program. For example, the liability associated with a program that requires an entity to remit environmental credits to satisfy an obligation on the basis of the entity’s activities (e.g., all emissions related to the entity’s operations must be remedied by submitting cash or credits to the regulator) should be accrued as the activities are performed. Other programs may not require a remedy in the form of cash or credits until a baseline amount of emissions has been exceeded. The ECO should be assessed as of the balance sheet date, irrespective of the settlement date or whether a compliance period is aligned with the balance sheet date or ends on a future date. In other words, a company’s operations — and not the date on which the company will satisfy the ECO by remitting credits (which often trails the compliance period by a few months) — will generally give rise to an ECO.

The proposal also stipulates that an obligation associated with a program that requires an entity to remit to a regulator a fixed number of credits as of a specified date solely on the basis of the entity’s ability to exist as a business as of the date on which a regulator assesses or levies an obligation should be accrued as of that date (i.e., the liability has been incurred as there is an unavoidable obligation). In this scenario, a corresponding asset should be recorded and amortized over the compliance period.



#### **Connecting the Dots**

When an entity is legally obligated to remit a fixed number of credits in the future, regardless of its ongoing operations, the entity should record an ECO for the full amount of its exposure as of the date on which a regulator assesses or levies an

obligation. In the example below, this date is the beginning of the compliance period. Under the proposed ASU, a corresponding asset is recorded at the same time. This asset represents a deferred expense and is amortized, resulting in the recognition of the associated expense over the compliance period. While the Board did not discuss an amortization method, we believe that a systematic and rational approach should be applied, which may result in the recognition of expense ratably over the compliance period.

### Example

For compliance year 2024 (which corresponds to calendar year 2024), Entity A is required to remit to regulators 100 credits or pay a monetary fine on March 31, 2025, regardless of its ongoing operations or emission activities. Entity A would recognize the full ECO as of January 1, 2024. Because A would recognize a corresponding asset at the same amount, it would not recognize any expense on January 1, 2024. Instead, between January 1, 2024, and December 31, 2024, A would amortize the asset and recognize the expense ratably throughout the year.

## Measurement

### *Initial and Subsequent Measurement of the Asset*

Under the proposed ASU, environmental credit assets would be initially measured at historical cost in a manner consistent with permissible portfolio and costing methods. Proposed ASC 818-20-30-1 states that “[a]n environmental credit that is internally generated by an entity or received through a grant from a regulator or its designee(s) shall be initially measured at the transaction costs incurred, if any.” From a practical standpoint, we believe that this will result in the recognition of many granted or internally generated credits as assets recorded for the costs incurred to register or certify the credits, if any. Further, ASC 818-20-30-2 states that credits “obtained in a transaction initially measured in accordance with another Topic shall follow the requirements of that other Topic.”

The proposal stipulates that the subsequent measurement of environmental credits would be based on management’s reassessment of the probable settlement outcome of the credits. (See [Derecognition](#) section below.) If management determines that it is probable that the credit will be used to settle an ECO or transferred in an exchange transaction, it is appropriate to recognize the credit as an asset.

With respect to remeasurement, proposed ASC 818-20-35-3 states that “[a]n entity shall determine at each reporting date whether it is **probable** that an environmental credit recognized as an asset will be used to settle an [ECO].” Further, if such recognition is probable, the entity would classify the environmental credit as a compliance environmental credit. In such cases, the credit would not be subject to impairment testing or otherwise subsequently remeasured. Impairment testing is not deemed relevant for these credits since their cost basis contributes directly to the measurement of the associated ECO (see discussion of [“linked” ECO measurement](#) below) in such a way that any asset impairment would be accompanied by a reduction in the ECO.

Proposed ASC 818-20-35-4 states that “[a]ll other environmental credits recognized as assets shall be classified as **noncompliance environmental credits** and tested for impairment at the reporting date.” In addition, under proposed ASC 818-20-35-8, an entity may “elect an accounting policy to subsequently measure a class of eligible . . . noncompliance environmental credits at fair value at each reporting period date, with changes recognized in earnings.” Further, proposed ASC 818-20-35-5 indicates that “[i]f an environmental credit is reclassified from a compliance environmental credit to a noncompliance environmental credit or vice versa,” the entity would perform impairment testing “before applying the subsequent measurement guidance related to the new classification of the environmental credit.” Note that if the entity makes the fair value election for a class of eligible noncompliance credits, the

credits will continue to be measured at fair value even if the entity subsequently expects to use them to settle an ECO (i.e., the election is irrevocable).

The proposed ASU also provides illustrative examples related to applying the subsequent-measurement requirements to credit assets.

### ***Initial and Subsequent Measurement of the ECO***

Under the proposed ASU, the measurement of the ECO would, when available, be “linked” to the cost basis of the assets that will be used to settle the obligation. Measurement of this liability depends on (1) the entity’s intended manner of satisfying the obligation, (2) whether the entity has credits on hand to satisfy the obligation, (3) whether the entity has fixed-volume and fixed-price contracts to procure credits that can be used to satisfy the obligation or is entitled (i.e., has an unconditional right) to receive credits from a regulator, and (4) the market for the required environmental credits as of the balance sheet date. The measurement can be further disaggregated as follows:

- *Funded obligation* — The funded obligation refers to the portion of an ECO for which an entity has credits on hand that will be used to settle the ECO. Under the proposal, the ECO would be measured at the cost basis of these credits in a manner consistent with permitted portfolio or costing methods used to measure the environmental credit asset. Accordingly, the measurement of the liability and the asset would be linked. The funded ECO would be measured after the recognition and measurement (including reassessment of the credit on the basis of a change in intent, if applicable) of the environmental credit asset to ensure that the entity has appropriately identified the credits on hand that it intends to use to settle the liability.
- *Unfunded obligation* — The unfunded obligation refers to the remaining portion of the ECO:
  - *Cash settlement* — If an entity has the intent and ability to remit cash to satisfy an ECO, it would measure the ECO on the basis of the cash settlement amount.
  - *Firm commitment to procure credits* — If an entity has “an unconditional purchase commitment for a fixed quantity of environmental credits at a fixed price” or has the present right to receive credits from a regulator, it would measure the ECO in accordance with the cost basis of the credits to be obtained under the contract or grant (which might be zero in the case of credits granted by a regulator).
  - *Remaining unfunded obligation* — An entity would record the remaining unfunded obligation at the fair value, as of the balance sheet date, of the credits that will be necessary to settle the ECO in accordance with the guidance in ASC 820.



#### **Connecting the Dots**

When an entity receives, for example, credits with a zero cost basis from a regulator, it would record the corresponding ECO at the same amount, assuming those credits will be used to satisfy the ECO. Similarly, if an entity has a present right to receive credits from a regulator in the future that can be used to satisfy an ECO (in a manner consistent with a firm commitment with a third party to procure credits), the entity would also consider these credits when measuring the related liability. The Board addressed this treatment at its January 31, 2024, meeting and within the proposed ASU. The right to receive the credits must be unconditional.

These measurement principles should be applied as of each interim and annual balance sheet date. The difference between the current-period ECO measurement and previous-period measurement would be recorded in earnings and presented within the same income statement line item as the initial recognition and measurement of the ECO liability.

The proposed ASU also provides illustrative examples related to applying the recognition and measurement guidance to environmental credit obligations.

## Derecognition

Environmental credits would be derecognized in accordance with ASC 610-20 unless a scope exception applies. For example, for a transfer of an environmental credit in a contract with a third party in an exchange transaction, an entity would derecognize an environmental credit when control is transferred in accordance with ASC 606.

Proposed ASC 818-20-40-2 states:

At each reporting date, an entity shall reassess whether environmental credits shall continue to be recognized as assets in accordance with paragraph 818-20-25-1. If an entity determines that it is no longer **probable** that an environmental credit will be used to settle an **environmental credit obligation** or transferred in an **exchange** transaction, the entity shall derecognize the environmental credit through earnings.

Further, under proposed ASC 818-20-40-2, “an environmental credit previously derecognized or never recognized as an asset shall not subsequently be recognized as an asset.”

An entity would apply ASC 405-20 to the derecognition of an ECO. ECOs would generally be derecognized when the obligation to the regulatory authority is satisfied through a transfer of credits, cash, or both. Any gains or losses associated with the derecognition would be presented in the same income statement line as the initial and subsequent measurement of the ECO.

## Presentation

### Balance Sheet Impacts

Under the proposed ASU, an ECO and the corresponding environmental credit asset would be reported on the balance sheet on a gross basis (i.e., the compliance obligation cannot be presented net of the associated credits). Further, the classification of both the ECO and environmental credit asset would be based on the timing of expected remittance of the asset to satisfy the ECO. The Board noted that if it is “reasonably expected to be settled within one year,” the ECO, along with the environmental credit assets to be used to satisfy the obligation, would be classified as current liabilities and current assets, respectively. All other ECO liabilities would be classified as noncurrent.

In a manner consistent with the principles discussed above, environmental credits reasonably expected to be sold or traded within one year (or within the business’s operating cycle if it is not a year) would be classified as current assets. All other environmental credit assets would be classified as noncurrent assets.



### Connecting the Dots

We have received questions about the difference between a linked measurement approach to determining the ECO and a net balance sheet presentation of the ECO. We believe that these are distinct concepts that can (and often will) coexist when an entity measures and presents an ECO. Measurement of the ECO will be linked to the cost basis of the credits intended to be used to satisfy the ECO. When the cost basis is zero, this linked measurement approach appears to have the effect of netting down the amount of the ECO.<sup>3</sup> However, this is not the case when the credits to be used have a nonzero cost basis. We believe that there is support for linked measurement in theory because the intended use of those credits is to satisfy the ECO and, therefore, linked measurement best reflects the economic sacrifice the company is likely to make. We also believe that there is support for gross presentation of the ECO and the

<sup>3</sup> The ECO is lower, for example, than an amount measured by using the current fair value of the related credit.

related environmental credits intended to be used to settle the ECO. This is because an entity can change its intent related to the credits it designates to use to settle its obligation, including by selling the credits previously designated for compliance purposes and leaving its ECO uncovered. Before settlement, the credits represent assets that could be monetized, and the ECO is a discrete obligation to a third party. Furthermore, in a manner consistent with the principles discussed by certain board members, we do not believe that the right-of-offset requirements described in ASC 210-20-45-1 would be met in the assessment of these items for balance sheet netting.

## Impacts on the Statement of Cash Flows

The proposal does not provide specific guidance on the cash flows associated with environmental credit programs.

## Disclosure

The proposed ASU would require entities to provide a number of disclosures about assets and liabilities, including the following:

- “How the entity obtains the environmental credits (acquired, granted, internally generated, or received in a **nonreciprocal transfer**).”
- “How the entity uses or intends to use the environmental credits (sell or trade, to settle **environmental credit obligations**, or for voluntary purposes).”
- “The entity’s method for subsequently measuring environmental credits recognized as assets (first-in, first-out; average cost; or specific identification).”
- “If the entity accounts for environmental credits as a portfolio, how the entity determined the portfolio(s).”
- “A description of the activities or events that result in environmental credit obligation liabilities under those programs.”
- “The types of **environmental credits** accepted by those programs.”
- “The nature and timing of settlement provisions.”
- “Significant estimates and judgments made in accounting for the entity’s environmental credit obligation liabilities.”
- “How the unfunded portion of an environmental credit obligation liability is measured.”

An entity would also need to disclose information about the carrying amount of environmental credit assets and liabilities that are not considered individually significant as well as about the fair value judgments that apply to the entity’s policy elections related to the credits and measurement of the unfunded portion of its ECOs.

The proposal also contains examples illustrating the disclosure requirements.

## Other Topics

### Interaction With ASC 815

Under the proposed ASU, environmental credits and environmental credit obligations would be explicitly outside the scope of ASC 815. However, forward or option arrangements involving environmental credits would not automatically be excluded from the scope of ASC 815.

### Fair Value Option for ECOs

Regarding the ECO, an entity would be prohibited from electing the fair value option in ASC 825.

## Interaction With ASC 805

Under proposed ASC 805-20-25-15B, “[a]n acquirer shall recognize an **environmental credit** acquired in a business combination as an asset, regardless of whether it is **probable** that the acquirer will use that environmental credit to settle an **environmental credit obligation** or transfer the environmental credit in an **exchange** transaction.”

As indicated in paragraph BC116 of the proposal, “[t]he Board proposed this guidance to clarify whether environmental credits that an acquirer intends to use voluntarily represent an asset at the acquisition date.” This paragraph also indicates that the Board “expects that an acquirer would derecognize those environmental credits immediately following the acquisition date.”

## Effective Date and Transition

The proposed ASU’s effective date will be determined after the Board considers the comments it receives. The proposal further indicates that “[e]arly adoption would be permitted for both interim and annual reporting periods for which financial statements have not yet been issued (or made available for issuance).”

The proposed guidance would be applied retrospectively by making a cumulative-effect adjustment to the opening balance of retained earnings. However, full retrospective application would not be permitted.

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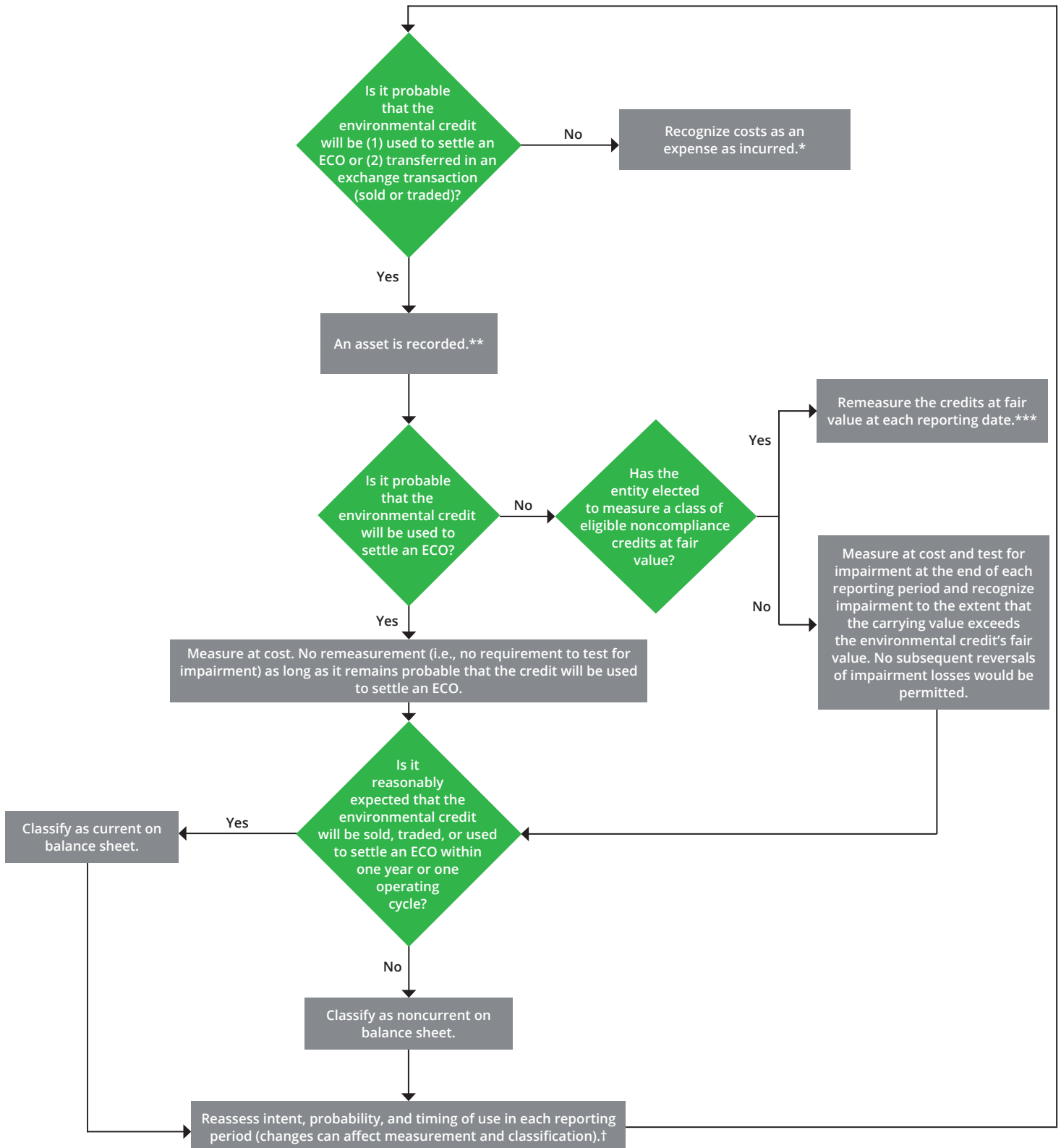
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## Appendix A — Decision Tree: Environmental Credit Assets



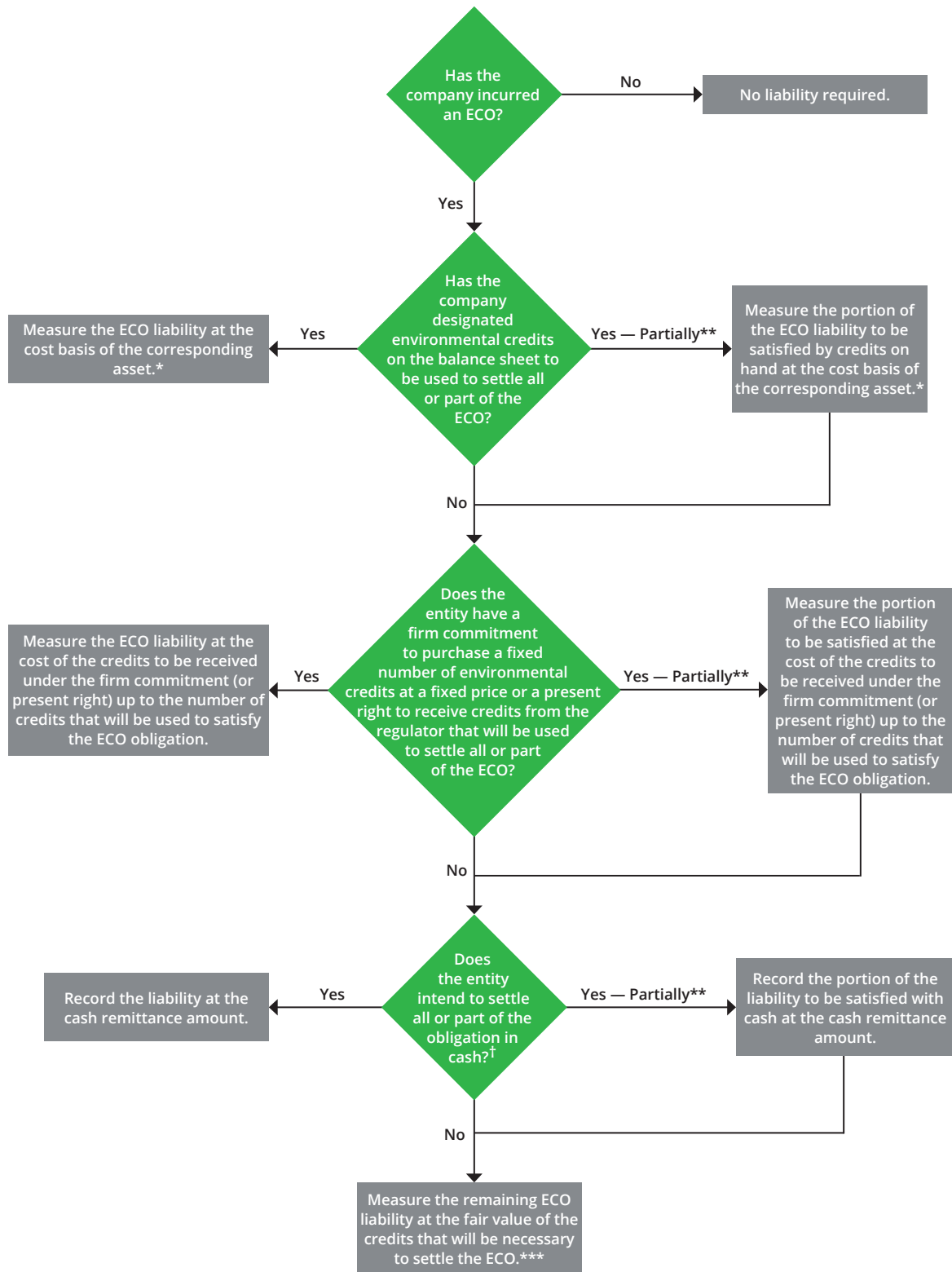
\* Costs are not eligible to be capitalized to another asset in accordance with other U.S. GAAP. Further, nonrefundable deposits associated with the acquisition of environmental credits for which it is not probable that the credits will be used to settle an ECO or transferred in an exchange transaction are not eligible to be capitalized and therefore should be expensed as incurred.

\*\* This applies unless the environmental credits were obtained as part of a transaction subject to other U.S. GAAP.

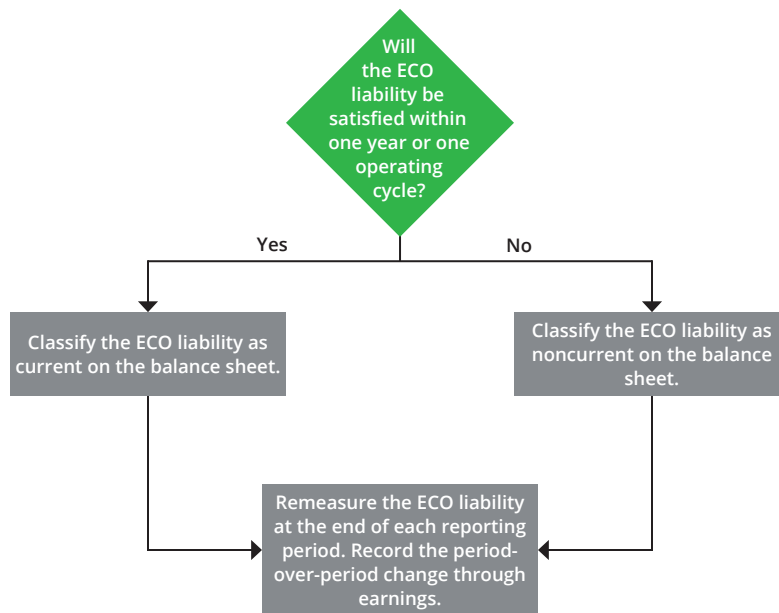
\*\*\* The fair value election is irrevocable. If an entity determines that a credit measured at fair value will be used to settle an ECO, it must continue to remeasure the credits at fair value as of each reporting date.

† As part of the reassessment process, an entity is precluded from identifying credits previously expensed (because it was not probable that they would be sold or used for compliance purposes) as credits to be used for compliance. This prohibition ensures that entities cannot reestablish the original cost basis of the credits, thus resulting in a gain upon the change in intent. Once expensed, those credits cannot be used to measure the ECO. If, upon reassessment, an entity reclassifies a compliance environmental credit as a noncompliance environmental credit, or vice versa, the entity must test the credit for impairment before applying the subsequent measurement guidance.

## Appendix B — Decision Tree: Environmental Credit Obligations



(Continued below)



- \* Cost basis may be zero in the case of credits provided to the entity at no cost. Cost basis of the credits used to measure the ECO liability may also reflect portfolio or costing methods applied to the measurement of the asset.
- \*\* In scenarios in which only a portion of the liability is expected to be measured at the cost basis of credits on hand, the remainder of the liability should be measured with the next step in the decision tree until the liability has been fully recognized. For example, this may result in an ECO liability for a single entity that is (1) partially linked to assets on hand, (2) partially linked to assets to be acquired under a firm commitment or to be received from a regulator (i.e., the entity has an unconditional right to receive these credits), and (3) partially measured at fair value.
- \*\*\* Fair value measurement should be based on the principles in ASC 820.
- † This measurement method is available only in the accounting for an ECO in which cash is an acceptable form of settlement with the regulator.

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