Heads Up | Volume 31, Issue 3
February 22, 2024

In This Issue

#DeloitteESGNow — FASB Makes Additional Tentative Decisions Related to the Accounting for Environmental Credit Programs

Overview

In May 2022, the FASB added to its technical agenda a project on the accounting for environmental credit programs. The objective of the project is to improve the recognition, measurement, presentation, and disclosure requirements related to (1) environmental credits and, when applicable, (2) compliance obligations incurred by an entity. Currently, the treatment of such credits and liabilities is not explicitly addressed in U.S. GAAP.

At its January 31, 2024, meeting, the Board made various tentative decisions related to this project, including those associated with the recognition and measurement of liabilities. Those decisions are discussed below. In addition, the decision trees in the appendixes of this *Heads Up* reflect the guidance on environmental credits and environmental credit obligations (ECOs) to date and may be used in determining the appropriate accounting under the Board's current tentative decisions.

Environmental Credit Obligations

Scope

At its meeting on October 11, 2023, the FASB made tentative decisions related to the scope of the project as well as to the recognition, measurement, and derecognition of environmental credits that are determined to be assets. The Board tentatively determined that ECOs within the scope of the project 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." For more information about the Board's tentative decisions at the October 11, 2023, meeting, see Deloitte's October 25, 2023, *Heads Up*.

Connecting the Dots

An entity's commitment to achieve certain climate goals or targets does not, in itself, meet the definition of an ECO. In a manner consistent with the principles discussed by a FASB staff member at the Board's May 25, 2022, meeting, we believe that 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. 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).

ECO Recognition

In a manner consistent with the definition of a liability, the Board tentatively decided at its January 31, 2024, meeting that an ECO liability 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 liability 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 met. The ECO liability 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.

However, in accordance with the meeting materials and Board discussion, 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 and 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 that a regulator assesses or levies an obligation. In the example below, this date is the beginning of the compliance period. Under the Board's tentative model, 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 amortization 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 liability 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.

Initial and Subsequent Measurement of the ECO

The Board tentatively decided that the measurement of the ECO liability should, when available, be linked to the cost basis of the assets that will be used to settle the obligation. Measurement of such 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 liability for which an entity has credits on hand that will be used to settle the ECO. The Board tentatively decided that the ECO liability should 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. Measurement of the funded ECO should occur 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 those 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 liability:
  - *Cash settlement* — If an entity has the intent and ability to remit cash to satisfy an ECO, it should measure the ECO liability on the basis of the cash settlement amount.
  - *Firm commitment to procure credits* — If an entity has "an existing commitment to purchase a fixed quantity of environmental credits at a fixed price" or has the present right to receive credits from a regulator, it should measure the ECO liability in accordance with the cost basis of the credits to be obtained under the contract (which might be zero in the case of credits granted by a regulator).
  - *Remaining unfunded obligation* — An entity should record the remaining unfunded obligation at the fair value of the credits that will be necessary to settle the ECO in accordance with the guidance in ASC 820.[1]

Connecting the Dots

When an entity receives, for example, credits with a zero cost basis from a regulator, it should record the corresponding ECO liability 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 acknowledged this treatment at its January 31, 2024, meeting. We believe that

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

the right to receive the credits must be unconditional and that an entity can include in the measurement of the ECO only those credits that it will receive on or before the settlement date (the date on which the entity will satisfy the ECO by remitting credits).

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 should be recorded in earnings and "presented in the same income statement line item as the initial measurement of the ECO liability."

Derecognition

The Board tentatively decided that entities should apply ASC 405-20 to the derecognition of an ECO liability. Any gains or losses associated with the derecognition should be presented in the same income statement line as the initial and subsequent measurement of the ECO.

Balance Sheet Impacts

The Board tentatively decided that an ECO liability and the corresponding environmental credit asset should be reported on the balance sheet gross (i.e., the compliance obligation cannot be presented net of the associated credits). Further, the classification of both the ECO liability and environmental credit asset should 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 liability, along with the environmental credit assets to be used to satisfy the obligation, should be classified as current liabilities and current assets, respectively. All other ECO liabilities should be classified as noncurrent.

At the October 11, 2023, meeting, the Board tentatively determined that environmental credits to be sold or traded are assets. Accordingly, 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) should be classified as current assets. All other environmental credit assets should 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.[2] 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 that, 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 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. However, some Board members indicated a preference for net balance sheet presentation, so it is possible that the FASB will revisit this decision as the project advances.

[2] The ECO is lower, for example, than an amount measured by using the current fair value of the related credit.

Statement of Cash Flow Impacts

The Board tentatively decided to not provide specialized guidance specific to the cash flows associated with environmental credit programs.

Other Topics

Interaction With ASC 815

The Board tentatively decided that "an entity should not evaluate environmental credits recognized as assets and ECO liabilities under [ASC] 815."

Fair Value Option

With respect to the ECO liability, the Board tentatively decided "that an entity should be prohibited from electing the fair value option in [ASC] 825."

At its December 20, 2023, meeting, the Board discussed the accounting for commodities (which remains on the research agenda) and whether fair value measurement should be permitted or required for entities engaged in commodity trading activities. Several board members suggested that the FASB staff make progress on the environmental credits project first, with the goal of leveraging some of that work as the Board further frames a potential project on commodities. Those board members view environmental credits as a useful test case for developing workable guidance on fair value measurement for fungible commodities, which could include the consideration of a fair value option. To date, the Board has not redeliberated this topic, but we expect it to discuss these issues further.

Asset Recognition

To clarify previous tentative decisions, the Board tentatively decided that "an entity should be prohibited from capitalizing the cost of environmental credits that will not be sold or used to settle an ECO liability, including as part of another asset" such as inventory or prepaid assets.

The Board also tentatively decided that "an entity should recognize nonrefundable deposits for environmental credits that are not probable of being used to settle an ECO or transferred in an exchange transaction as an expense."

Next Steps

The Board plans to continue its outreach to stakeholders.

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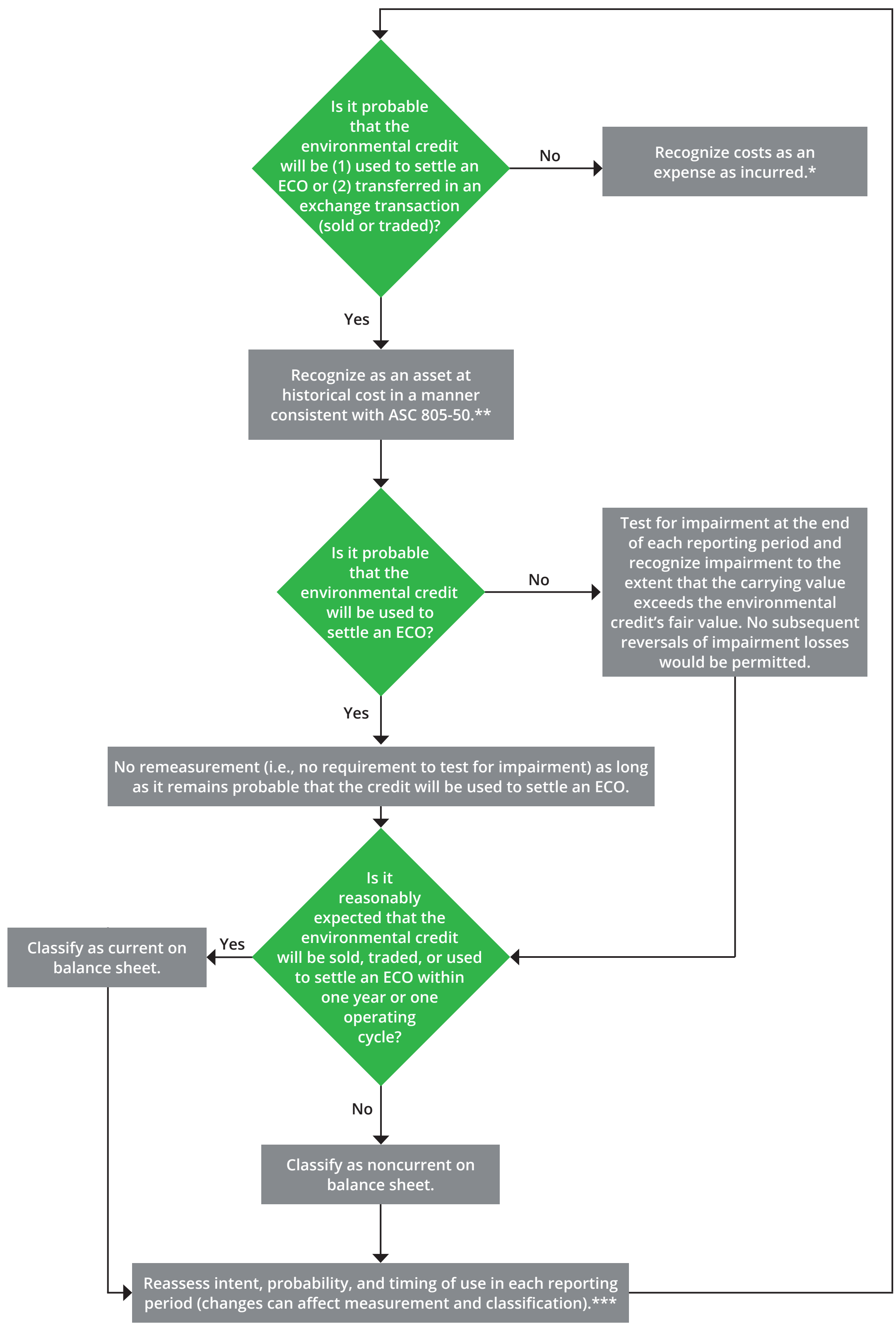
Appendix A — Decision Tree: Environmental Credit Assets

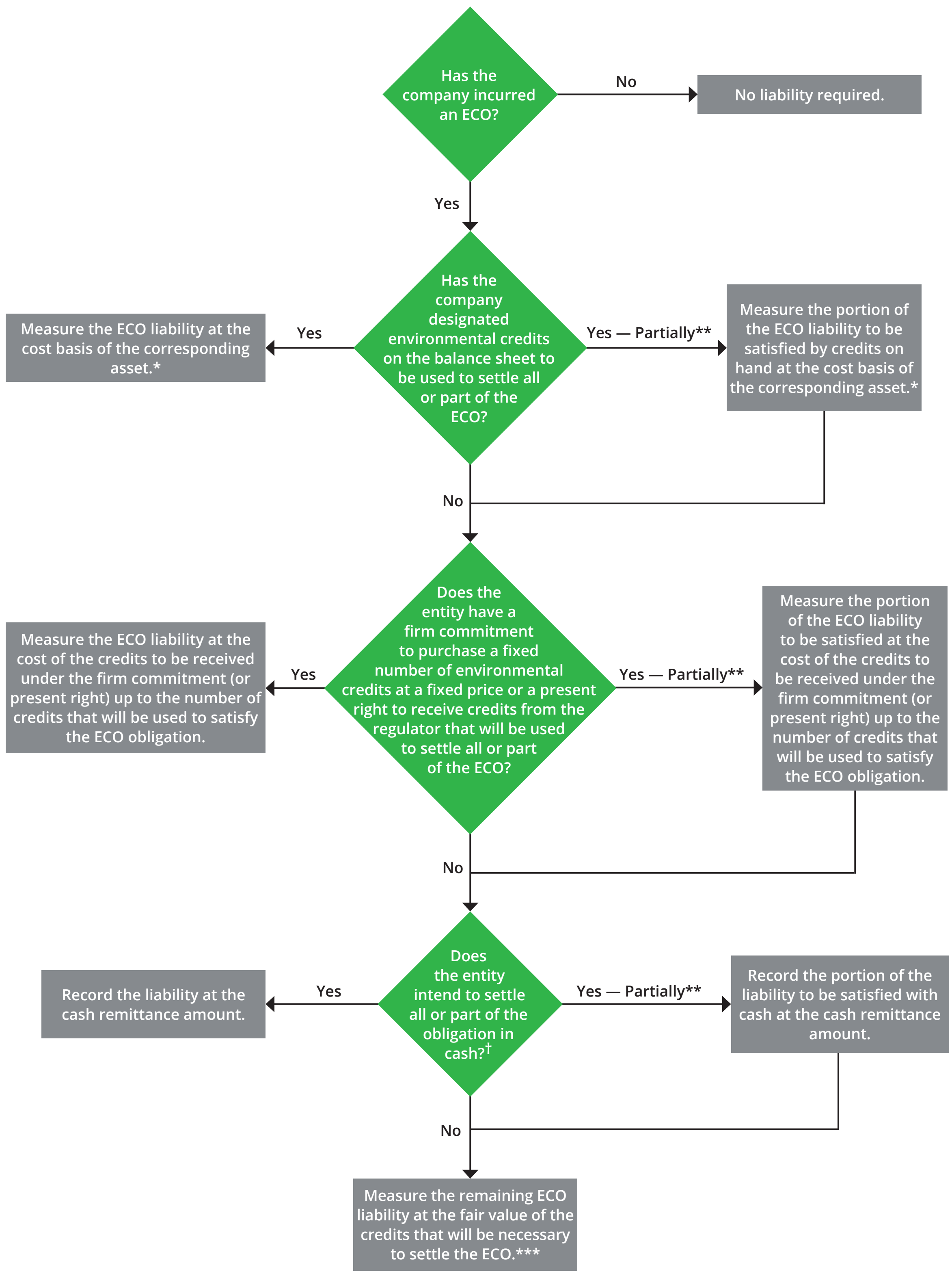


* Costs are not eligible to be capitalized to another asset in accordance with other U.S. GAAP. Further, nonrefundable deposits associated with the acquisition of environmental credits for which it is not probable that the credits will be used to settle an ECO or transferred in an exchange transaction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

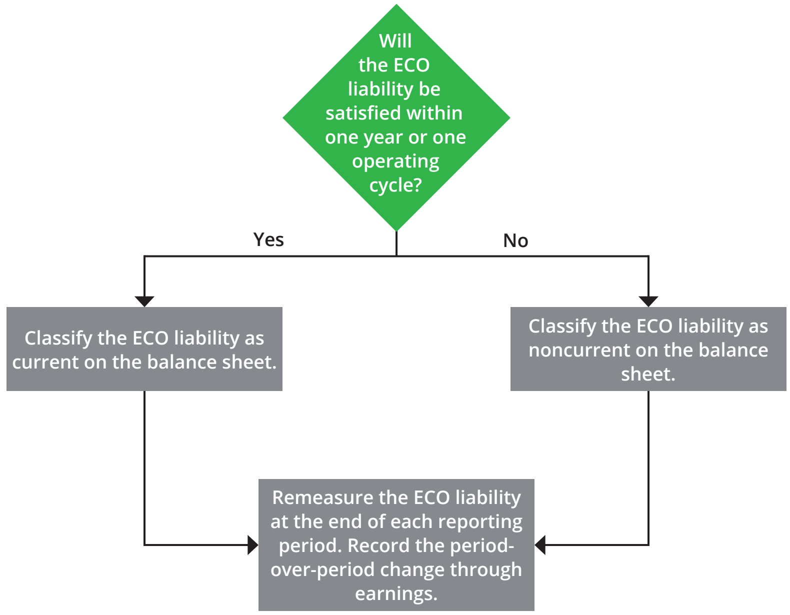
** This applies unless the environmental credits were obtained as part of a transaction subject to other U.S. GAAP.

***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: Measurement and Presentation of ECO Liabilities



(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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