ACCOUNTING FOR ENVIRONMENTAL MARKETS AND EMISSIONS TRADING

AN UPDATE ON PROGRESS TO DATE AND NEW RESEARCH FINDINGS

WHY DO WE NEED ACCOUNTING STANDARDS FOR ENVIRONMENTAL MARKETS?

Environmental markets are often established to use market-based mechanisms to reduce the pollution of air and water resources, and such markets have emerged as an important tool for "internalizing" the externalities associated with the activities of governments and private companies. Currently, more than 1,200 environmental markets are in operation in the United States, including wetland mitigation banks, water quality trading, and carbon cap-and-trade markets. In the past year alone, companies in U.S. cap-and-trade systems spent more than **$4.8 billion in carbon allowance auctions**. For many firms operating in cap-and-trade systems, emissions liabilities comprise 1-3% of the total financial liabilities on their balance sheet and this liability is growing.

Despite the significant and growing size of environmental markets, there is no guidance on how firms should account for these transactions on their balance sheets. In the absence of guidance, companies are not using consistent methods to record and value allowances and liabilities on their balance sheets, and in many cases do not report them at all.

Accounting guidance from the Financial Accounting Standards Board (FASB) and Governmental Accounting Standards Board (GASB) on transactions related to environmental markets would support the objectives of accounting, providing information that is useful to existing and potential investors, lenders, policymakers, and the public. Due to the public-private nature of many of these markets, it may be appropriate to initiate a joint project between GASB and FASB. This would also support other efforts to increase disclosure related to climate risks, such as those of Moody's, Securities and Exchange Commission, and Sustainability Accounting Standards Board.

RECENT DELIBERATIONS BY FASB AND GASB

The FASB began deliberating on the topic of emissions trading schemes in the early 2000s, but the issue was ultimately removed from the agenda in 2014 without resolution. In 2014, the GASB added the topic of "Emissions Trading (Carbon Credits)" to its list of Potential Projects. During these years, the size and scale of environmental markets and emissions trading schemes has grown significantly, making this guidance more necessary than ever.

In August 2018, Earth Economics submitted an ***agenda request*** to the FASB, supported by a technical research report, requesting the topic of environmental markets be added to their research agenda as a project, with the goal of developing an accounting standard. At a 2019 Board meeting, however, the FASB ***elected not to add*** the topic to their research agenda at this time, citing that it was a large project that would compete with other existing priorities.

Earth Economics believes is it crucial that accounting guidance be provided in the near future, as the size and scale of environmental markets will continue to grow. Earth Economics will continue supporting the FASB, GASB, industry groups, and investor networks to advance this much-needed guidance.

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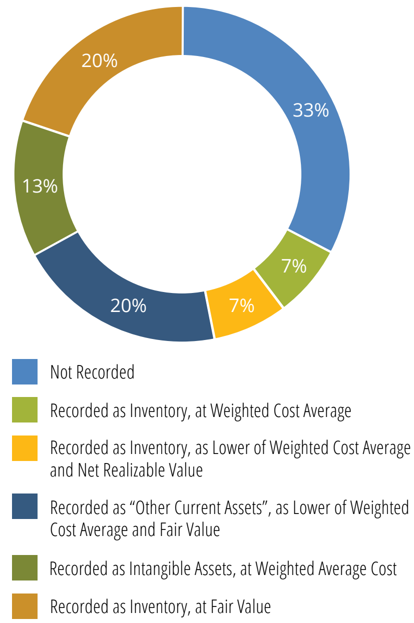
EARTH ECONOMICS' RESEARCH AND FINDINGS

In 2018, Earth Economics released the report ***Accounting for Emissions Trading and Other Environmental Market Transactions: Emerging Opportunities for the FASB***, which summarized the current state of knowledge and practice related to accounting for emissions trading. The report also included results from a survey conducted across firms representing 40 percent of carbon allowances bought and sold in California. The report found that despite the growing size and importance of these environmental markets, participants face several unique challenges related to accounting for these transactions, many of which can be addressed by the FASB and GASB. In the California cap-and-trade system, for example, firms must determine an accounting treatment and valuation method for free allowances provided the California Air Resources Board, purchased allowances bought on the California Auction, allowances sold in third-party markets, and liabilities for compliance with the policy. Prices in these markets fluctuate significantly, so the recording and valuation method selected can have a material impact on financial statements. Earth Economics found that in the absence of guidance, companies are not consistent in their selection of methods to record and value allowances and liabilities on their balance sheets. In many cases, companies do not report them at all. Survey responses highlighted the wide variety in practices, and the significant uncertainty in accounting treatments for emissions trading schemes. This finding is summarized in the figure at right.

PURCHASED ALLOWANCE RECORDING METHODS



ABOUT EARTH ECONOMICS

As a leader in ecological economics, we work to quantify and value the benefits that nature provides through innovative analysis. We are proud to partner with and make recommendations to governments, tribes, organizations, private firms, and communities around the world. Together, we can create a future where communities, nature, and industry all thrive together.

Interested in learning more? Connect with us today!

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