The Association of
Accountants and
Financial Professionals
in Business

Via email
To: director@fasb.org

March 24, 2023

Ms. Hillary H. Salo
Technical Director
Financial Accounting Standards Board
801 Main Avenue
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Definition of a Derivative

Dear Ms. Salo:

The Financial Reporting Committee (FRC) of the Institute of Management Accountants (IMA) is writing to express its views on the Financial Accounting Standards Board's (FASB or Board) research project, *Definition of a Derivative*.

The IMA is a global association representing over 140,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The FRC includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy, Financial Reporting Committee).

We believe the FASB should promote the portion of its research agenda project, *Definition of a Derivative*, relating to the accounting for financial instruments with environmental, social and governance (ESG)-linked features to its active technical agenda to provide guidance on whether the features embedded in a sustainability-linked bond[1] meet the definition of a derivative and, if

[1] Sustainability-linked bonds (and loans) are those where the issuer can use the proceeds for general corporate purposes. The interest rate on the bond or loan adjusts based on a change in an environmental, social or governance measure of the issuer. Examples of key performance indicators used to determine changes in the interest rate on sustainability-linked bonds include changes in greenhouse gas emissions, water usage, diversity in senior leadership roles or in suppliers to the issuer, or combinations of key performance indicators.

so, whether the features require separation. According to a recent report by Federated Hermes International, cumulative issuances of sustainability-linked bonds at the end of 2021 was $109 billion, a little more than two years after the first issuance. By the end of 2022, cumulative issuances of sustainability-linked bonds had increased to almost $200 billion. After issuances of green bonds (including sustainability-linked bonds) in 2022 failed to meet forecasts, issuances are expected to recover in 2023. Considering the significant market for sustainability-linked bonds, we believe it is imperative that the FASB provide clarity on the accounting for those financial instruments.

Consistent with our prior observations that the Emerging Issues Task Force (EITF) is an underutilized resource, we recommend the Board assign responsibility for addressing the accounting for ESG-linked features to the EITF. We believe this issue can be expeditiously addressed by the EITF, which has a history over its life of quickly addressing practice issues and it would appear the EITF has the capacity to develop guidance on this topic.

We understand that some accountants have concluded that (1) the embedded sustainability-linked feature qualifies as a derivative, (2) the embedded features do not qualify for any of the scope exceptions to ASC 815 *Derivatives and Hedging*, and (3) that the embedded features are not clearly and closely related to the economic characteristics and risks of the debt host contract and therefore require separation. The result of those conclusions is that an issuer is obligated to separate the sustainability-linked feature from the debt host contract and recognize it at fair value, with changes in fair value after the issuance recognized in earnings. We believe a preferable model would be for the issuer to recognize the impact of the adjustment to the terms of the sustainability-linked debt using the effective interest method.

Although we understand most reporting entities currently conclude the fair value of the embedded sustainability-linked feature is not material at the issuance date, separating the sustainability-linked feature requires reporting entities to establish processes and controls over those processes to measure the fair value of the sustainability-linked feature in subsequent reporting periods to comply with the requirements of ASC 815. We do not believe that marking a sustainability-linked feature to fair value each period serves preparers or users of financial statements well.

From a preparer perspective, accounting for the sustainability-linked feature separately will require reporting entities to incur costs to monitor the fair value of the separated feature and recognize changes in the fair value in income, which is not information that reporting entities generally use in making decisions regarding the business. Recognizing the separated ESG-linked feature at fair value requires a reporting entity to estimate the likelihood it will satisfy the key performance indicators selected by the date or dates specified in the financing arrangement at the end of each reporting period. The longer the time to those dates, the more difficult it will be to develop such estimates, which will potentially lead to a significant amount of volatility in the fair value of the ESG-linked feature from period to period and scrutiny by the reporting entity's auditor, adding further cost to a requirement that the ESG-linked feature be separated from the debt host contract.

From a user perspective, marking the ESG-linked feature to fair value through earnings will result in a disconnect between the cash interest paid on the debt and the interest expense recognized in each period because the mark to fair value adjustment will pull forward the additional interest expense (if the rate is likely to increase) or the reduction in interest expense (if the rate is likely to decrease) for the remaining term of the borrowing. We believe many of the reasons cited by the Board for issuing Accounting Standards Update (ASU) No. 2020-06 *Debt – Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging – Contracts in Entity's Own Equity (Subtopic 815-40)* apply equally to separately accounting for a sustainability-linked feature that will potentially result in an adjustment of the interest rate on the debt security separately from that debt security. As noted in paragraph BC23 of the basis for conclusions to ASU No. 2020-06, many users of financial statements believe the cash (coupon) interest expense is more relevant for their analyses. We believe not separating the ESG-linked feature from the debt host agreement and applying the effective interest method for changes in the interest rate based on meeting, or failing to meet, key performance indicators would provide users more relevant information. Further, we do not think separating the sustainability-linked feature from the debt host is a clear outcome under existing GAAP.

## ASC 815 Scope Exceptions

We recognize that the scope exceptions currently provided in paragraph 13 to 82A of ASC 815-10-15 do not explicitly provide an exception for a sustainability-linked feature. However, that has more to do with the fact such financial instruments did not exist at the time the FASB issued Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities*. We believe a sustainability-linked feature should qualify for the scope exception in paragraph 59(a) of ASC 815-10-15 based on the nature of the underlying (the occurrence or nonoccurence of a change in an environmental, social or governance measure that is specific to the issuer of the sustainability-linked bond). The Board discussed its views on whether arrangements with physical variable underlyings should be accounted for as derivatives in paragraph 252 of the Basis for Conclusions, which states:

> In concept, ***any observable variable, including physical*** as well as financial variables, ***may be the underlying for a derivative instrument***. For example, a contract might specify a payment to be made if it rains more than one inch on a specified day. However, ***throughout the project that led to this Statement, discussion focused on more traditional derivatives for which the underlying is some form of price, including an interest rate or exchange rate***. For example, paragraph 6 of the Exposure Draft referred to "a rate, an index of prices, or another market indicator" in describing an underlying. ***Relatively late in the process that led to this Statement, the Board considered expanding its scope to include all derivatives based on physical variables but decided not to do so. It was concerned that constituents had not had sufficient opportunity to consider the implications and potential measurement difficulties of including contracts based on physical variables. The Board believes many contracts for which the underlying is a physical variable are currently accounted for as insurance contracts, and it considers that accounting to be adequate for now***. However, the Board decided that any derivative instrument that is traded on an exchange, including one based on a physical variable, should be subject to the requirements of this Statement. Accordingly, any derivative based on a physical variable that eventually becomes exchange traded will automatically become subject to the requirements of this

> Statement. The Board does not believe that measurement or other implementation problems exist for exchange-traded instruments. [Emphasis added]

The Board did not provide examples of what types of underlyings qualify as “another physical variable” in paragraph 88(g) of ASC 810-10-15 but appears to have intended something other than a climatic or geological condition. Although the issuer is involved in satisfying the conditions on which the adjustment to the terms of the sustainability-linked financial instrument is based, we believe that does not disqualify the underlyings from being physical variables. Contracts where the change in terms is driven by a specified change in the issuer’s greenhouse gas emissions or employee diversity without any monetary measure clearly do not have a financial variable. However, as noted above, practice has generally evolved to concluding that none of the existing scope exceptions apply to sustainability-linked features.

We recommend the FASB take one of the following alternatives to address this issue. We have listed them in the order of our preference.

1. Provide an exception for a nonfinancial variable that is specific to a party to the contract.
2. Establish principles for determining when an underlying qualifies as “another physical variable”, including whether a reporting entity’s involvement in satisfying the variable precludes the underlying from being a physical variable.
3. Provide a scope exception specifically for sustainability-linked features for the issuer and investor.

**<u>Scope Exception for Nonfinancial Variables Specific to a Party to the Contract</u>**

Our preferred solution to fixing the scope of ASC 815 is taken from the definition of a “derivative” in IFRS 9 *Financial Instruments*. Under IFRS 9, the first characteristic of a derivative is:

> … its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, ***provided in the case of a non-financial variable that the variable is not specific to a party to the contract*** (sometimes called the ‘underlying’). [Emphasis added]

Under IFRS 9, if an adjustment to the terms of a sustainability-linked bond results from a change in an indicator specific to the issuer (i.e., a reduction in the interest rate on the bond if the issuer achieves targeted reductions in its greenhouse gas emissions or meets diversity targets by a specified date), that feature does not qualify as a derivative. Rather than changing the definition of a derivative in ASC 815, which might lead to unintended consequences, we believe adding a scope exception that exempts nonfinancial variables where the variable is specific to a party to the contract would accomplish the objective of removing sustainability-linked features from the scope of ASC 815.

Adding such a scope exception would also avoid the requirement to separate other embedded features from host contracts that we have seen, such as a provision embedded in a license agreement that requires a licensee to make payments to the licensor if the licensee obtains FDA approval for a drug under development. Similar to our views on separating a sustainability-linked feature from a debt host contract, we do not believe accounting for such a payment provision as a derivative provides relevant information to users of an entity's financial statements.

**Establish Principles for Identifying "Another Physical Variable"**

If the Board concludes that adding a scope exception for nonfinancial variables specific to a party to the contract is not possible, we believe the Board should provide guidance on what qualifies as an "other physical variable" in paragraph 59(a) of ASC 815-10-15. The discussion in paragraph 252 of the Basis for Conclusions to Statement 133 appears to suggest that underlyings are based on either physical or financial variables. If that is correct, an "other physical variable" should be interpreted broadly to include sustainability-linked features if the adjustment to the terms of the contract is not also indexed to a financial variable, such as a monetary amount. Further, we do not believe the issuer's involvement in affecting the outcome of the sustainability-linked feature changes the underlying from a physical variable to a financial variable because the nature of the underlying (i.e., change in greenhouse gas emissions or diversity statistics) is ultimately a physical variable.

**Specific Scope Exception**

If the FASB does not agree with the previous alternatives, we recommend the Board provide a scope exception for sustainability-linked features that would apply to both issuers and investors. We do not believe users of financial statements obtain relevant information when the accounting for the adjustment to the terms of the financial instrument are separated from the accounting for the financial instrument for reasons like those cited in ASU No. 2020-06.

**Clearly and Closely Related**

In addition to addressing the scope of ASC 815, we believe the Board should provide additional guidance relating to the application of the condition in paragraph 1(a) of ASC 815-15-25 on whether the economic characteristics and risks of an embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract. Some accountants appear to have concluded that sustainability measures are not clearly and closely related to credit risk on the host contract. However, we understand that the credit rating agencies consider environmental, social and governance risks in establishing issuer ratings. If ESG risks are relevant to rating agencies, it seems to us that adjustments to the terms of a debt instrument for changes in those risks might be considered clearly and closely related to the credit risk of the host contract. Accordingly, it would be helpful if the FASB provided interpretive guidance on how to assess whether an embedded provision, such as a sustainability-linked feature, is clearly and closely related to the interest rate or credit risk of a debt host contract.

While guidance on determining whether an embedded feature is clearly and closely related to the host contract would be less urgent if the Board adds our preferred scope exception, we believe interpretive guidance would still be helpful given the relative lack of guidance in ASC 815.

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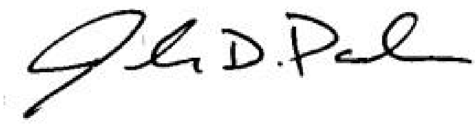
We would be pleased to discuss our comments with the FASB or its staff at your convenience.

Sincerely,



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