

IMA FRC comment letter to FASB on definition of a derivative (ESG-linked instruments)

Friday, March 24, 2023

The IMA[®] (Institute of Management Accountants) Financial Reporting Committee (FRC or Committee) issued a comment to the Financial Accounting Standards Board (FASB or Board) that endorses a FASB project, *Definition of a Derivative*, relating to the accounting for financial instruments with environmental, social and governance (ESG)-linked features. Sustainability-linked instruments allow an issuer to use the proceeds for general corporate purposes, but the interest rate adjusts based on ESG measures, such as greenhouse gas emissions, water usage, or diversity in senior leadership.

The FRC observes that some accountants have concluded that (1) the embedded sustainability-linked features qualify as a derivative, (2) the embedded features do not qualify for any of the scope exceptions to Topic 815, *Derivatives and Hedging*, and (3) the embedded features are not clearly and closely related to the economic characteristics and risks of the debt host contract, and therefore the features 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 is recognized in earnings.

The FRC believes that a preferable model would be for the issuer to recognize the impact of the adjustment to the terms of the sustainability-linked debt by applying the effective interest method. As detailed in its comment letter, the FRC recommends the FASB consider the following alternatives to address this issue (in preferential order):

1. Provide a scope exception under Topic 815 for nonfinancial variables specific to a party to a contract;
2. Establish guidance for identifying an underlying that qualifies as “another physical variable” as provided in Topic 815; or
3. Provide a scope exception specifically for sustainability-linked features for both an issuer and investor.