

Sustainability linked financing – accounting considerations

Reporting Update



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Highlights

- Sustainability bonds
- ESG linked loans
- ESG linked derivatives
- Supplier financing

The link between financing and sustainability

Organisations are considering all aspects of their operations to identify opportunities to align their business models with the increasing demand by investors and consumers for more sustainable growth. ESG initiatives are being integrated into all elements of their operations, including financing activities.

Financiers are also aware of the potential change in risk profile of customers that are not engaging to move to more sustainable business practices. As a result of these developments, financing arrangements are evolving to incorporate ESG factors by rewarding organisations that achieve their ESG targets with a lower cost of borrowing.

This is leading to a new range of ESG based financing initiatives, which raise potential financial reporting considerations.

This publication outlines the main types of ESG financing initiatives that are emerging both domestically and globally and the accounting implications.



Sustainability linked financing

Accounting considerations by the borrower

April 2022

Introduction

The link between financing and sustainability

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Financiers are also aware of the potential change in risk profile of customers that are not engaging to move to more sustainable business practices. As a result of these developments, financing arrangements are evolving to incorporate ESG factors by rewarding organisations that achieve their ESG targets with a lower cost of borrowing.

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The International Capital Market Association has issued guidelines on Sustainability bonds and Sustainability linked bonds. Sustainability bonds are debt instruments where the proceeds are used exclusively to finance a combination of green and social projects. Sustainability linked (ESG linked) bonds or loans are borrowings where the pricing varies depending on whether the issuer achieves its ESG objectives within a predefined timeline.



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Sustainability bonds



Sustainability bonds

Green Bonds

Green bonds contain specific requirements that the proceeds will only be used on specified environmental or climate related projects. Globally the proceeds have been used predominantly to fund renewable energy projects, low carbon transportation projects and energy efficient buildings. Green bonds issued in Australia have also been earmarked for similar projects.

Green bond issuances have terms that are similar to a plain vanilla bond, with regular coupon payments based on either a fixed or variable interest rate and the principal repayable at maturity.

Blue Bonds

Similar to Green bonds, Blue bonds are also starting to increase in prevalence. These bonds function similarly to Green bonds, the main difference is that Blue bonds are typically used for sustainability initiatives associated with ocean health or other water related environmental endeavours.



Most sustainability bond issuers in Australia engage a third party to conduct an independent audit or assurance to discharge their reporting obligations to the lenders that the funds are being used for the intended purposes.

Sustainability bonds – financial reporting considerations

Generally an issuer accounts for such bonds in a manner similar to vanilla bonds, that is, they are recognised as financial liabilities measured at amortised cost.

The bonds are initially recognised at fair value adjusted for transaction costs. Generally the fair value at initial recognition is the proceeds from the bond issuance. Interest expense is recognised over the term of the bond, based on the effective interest rate, which would likely approximate the contractual rate of interest adjusted for transaction costs.

Given the commitments attached to the issuance of such bonds, an issuer may need to consider whether the requirement to use the funds for the specific green purposes is a type of debt covenant. Considerations may include:

Is there flexibility to apply the funds raised for an alternate purpose?

What are the implications if the funds are not used for the designated green purpose? Is this a breach of contract that makes the debt repayable on demand?

Does the issuer have controls in place to enable it to report how the funds have been used?

What additional information should the issuer include in its financial report?

ESG linked loans



ESG linked loans

ESG or sustainability linked loans or bonds are borrowings where the interest payable varies depending on whether the issuer achieves specified ESG targets. These targets are usually aligned with the borrower's ESG goals.

Commonly under such arrangements, depending on whether the specified target is met, the cost of borrowing increases or decreases by a predetermined amount.

Unlike Sustainability bonds, ESG linked loans provide greater flexibility to the borrower as they can typically be used for general corporate funding purposes.

Wide ranging ESG KPIs can be linked to the borrowing. These ESG KPIs are bespoke and vary from, for example, climate based sustainability targets to diversity quotas. Multiple different discounts linked to different KPIs can be attached to a single loan. A borrower's cost of funding therefore varies depending on whether the specified ESG targets are met.

Examples of ESG targets include:

- Scope 1 Carbon Emissions will be below X tonnes p.a. by 20XX
- Tyre manufacturer to ensure each tyre includes 25% recycled rubber by 20XX
- X number of hours of diversity and inclusion training to be delivered to XX employees by 20XX
- X number of employees completed mental health first aid program by 20XX

Most borrowers engage a third party to provide independent assurance or conduct an audit to confirm that the KPIs are met.

ESG linked loans – financial reporting considerations

Generally ESG linked borrowings are accounted for as financial liabilities measured at amortised cost.

Initially the bonds are recognised at fair value adjusted for transaction costs. At inception, the fair value typically equals the proceeds from the bond issuance. Interest expense is recognised over the term of the bond, based on the effective interest rate.

Complexity in the accounting for these arrangements arises due to the variability in the amount of interest payable which is dependent on whether the ESG KPI targets are met.

Considerations include

At **initial recognition** of the borrowing, is the expected impact of the KPI target included in estimating the effective interest rate?

Over the term of the borrowing, how are any changes in expected cash flows due to the ESG KPIs accounted for?

- If they are considered to be floating rate borrowings, the effective interest rate is revised to reflect changes in cash flows due to the KPI target.
- If they are not considered to be floating rate borrowings, the effective interest rate remains unchanged and the carrying amount is adjusted to reflect the change in cash flows with the change recognised in P&L.

ESG linked loans - example

Example

An organisation takes out a 5-year ESG linked loan of \$1m with a fixed interest rate of 5% p.a. Under the agreement the organisation receives a 10 basis points (0.1%) discount for the remainder of the term once 200 employees have completed their mental health first aid training.

The organisation expects that the training will be completed by the end of year 2, such that the discount will be applicable for years 3 to 5 of the loan.

Effective interest rate at initial recognition

At inception, what are the considerations in estimating the effective interest rate (EIR)? For example:

The EIR is the contractual 5% p.a. without any consideration of the potential discounts to be earned in later periods

or

The EIR is 4.94%, which reflects the expectation of receiving the 10bp discount in years 3 – 5.

Assume that at initial recognition, the organisation estimates its EIR to be 4.94% based on the expectation that it will meet its target at the end of year 2.

At the end of the year 1, the organisation's expectation changes, it now estimates the training will not be completed until the end of year 3 and the 10 basis points discount will only be applicable for years 4 – 5 of the loan.

ESG linked loans - example cont.

How should the change in expectations be recorded at the end of Year 1?

This depends on how Company A views the arrangement, is it akin to a floating interest rate arrangement or is it a fixed rate arrangement? The following illustrates the impact of the two approaches.

Fixed interest rate approach

The organisation updates the carrying amount of the liability and continues to recognise interest at 4.94%

There is no change in the EIR from the change in expectation. The carrying amount of the loan is remeasured, based on the new expected cash flows at the original effective interest rate of 4.94%.

End of	Loan balance	P&L
Year 1*	\$1,000,337	\$50,337
Year 2	\$999,783	\$49,446
Year 3	\$999,201	\$49,418
Year 4	\$999,591	\$49,390
Year 5	0	\$49,409
Total		\$248,000

* P&L Includes \$49,429 interest (at 4.94%) and the impact of change in estimated cash flows of \$908.

Floating interest rate approach

The effective interest rate is adjusted to reflect the change in estimated cash flows.

The EIR is updated to reflect the change in expected cash flows. Accordingly, at the end of Year 1, the EIR is adjusted to 4.97%

End of	Loan balance	P&L
Year 1	\$999,429	\$49,429
Year 2	\$999,086	\$49,657
Year 3	\$998,726	\$49,640
Year 4	\$999,347	\$49,622
Year 5	0	\$49,653
Total		\$248,000

ESG linked loans - example cont.

In summary, there are different approaches to account for the conditionality related to the contractual interest rates.

For example, an organisation may estimate the EIR at inception as the contractual 5% p.a. without any consideration of the potential discounts that may occur in later periods.

In addition, it may elect to recognise the change in expectations when the actual change occurs as a change in interest rate (similar to a floating interest rate instrument).

Floating interest rate approach

The effective interest rate is 5% at inception.

There is no change in the EIR when the expectations change at the end of Year 1. The EIR is revised when the KPI is met at the end of Year 3 with no change in the carrying amount of the loan.

End of	Loan balance	P&L
Year 1	\$1,000,000	\$50,000
Year 2	\$1,000,000	\$50,000
Year 3	\$1,000,000	\$50,000
Year 4	\$1,000,000	\$49,000
Year 5	0	\$49,000
Total		\$248,000

ESG linked loans - other considerations

Is there an embedded derivative?

The other complexity in accounting for ESG linked loans is the consideration of whether there is an embedded derivative that requires separation which will be at fair valued through profit or loss. That is, is the feature that gives rise to the variability in interest rate a derivative?

Typically the feature that gives rise to the variability in ESG linked loans relates to the borrower's ability to implement non-financial measures within its operations, such as reducing its scope 1 carbon emissions. In such scenario, the interest feature does not meet the definition of a derivative because the underlying variable that drives the variability is a non-financial element and it is specific to the borrower.

Derivatives exist where the variability arises from non-financial elements that are not specific to the borrower, or where the variability is due to, for example, financial indices, rates or prices of a financial instrument such as equity or debt security or commodity.

Example embedded derivatives

An organisation is considering two different ESG linked loans with the following clauses:

Loan 1: If the organisation fails to implement flood mitigation strategies XYZ by year 2, a penalty of 10bp is added to the interest rate on the borrowing.

Loan 2: If a flood occurs in X region before year 2, a penalty of 10bp is added to the interest rate on the borrowing.

Which of these loans might contain a derivative?

Loan 1: As the variability arises due to a non-financial element that is specific to the organisation, it is likely that this does not contain a derivative.

Loan 2: As the variability is due to a non-financial element that is not specific to the organisation, it is likely that there is a derivative.

Other ESG financing considerations



ESG linked derivatives

Other forms of ESG financing include ESG linked derivatives that are often connected to an underlying borrowing arrangement. These derivatives are bespoke and customised to align with the ESG targets of the corporate. They are structured for the borrower to achieve a lower cost of funding if certain ESG KPIs are met. For example, an organisation with a floating rate borrowing may enter into an interest rate swap where:

- the receive leg is based on a floating rate +/- an adjustment linked to an ESG KPI.
- the pay leg is based on a fixed interest rate.



The ESG components are similar to those discussed in ESG linked bonds where the organisation will be either rewarded for meeting the ESG targets by an increase in the receive leg or penalised by a decrease in the receive leg if they fail to meet their ESG targets.

Assurance may be required to confirm that the ESG targets are met.

ESG linked derivatives are measured at fair value through profit or loss. Complexities may arise for organisations intending to apply hedge accounting to these derivatives. For example:

- Does the ESG feature give rise to ineffectiveness due to the debt not having similar underlying ESG features built into the interest rate?

Supplier financing



Supplier financing, a form of supply chain financing which is used by corporates to accelerate payments to their suppliers and optimise their working capital is another form of financing that organisations can look into as part of their overall sustainability financing.

Such arrangements have been subject to media and regulator scrutiny from the perspective of the pressure such arrangements may place on small businesses to either accept a discount for immediate payment or extend the terms of trade.

As part of sustainable financing

Conversely, large corporates can use supplier chain financing to incentivise their suppliers to commit to a sustainable policy. For example, accelerated payments are made if the supplier meets specified ESG KPIs.

From a financial reporting perspective, corporates disclosing details about their supplier financing arrangements may consider whether they form part of their sustainable financing strategy and if so, the information to include for users to understand how the use of supplier financing arrangements aligns with their ESG ambitions.

In summary



In summary



Initiating ESG financing transactions

Including ESG measures in financing arrangements is likely to be new to many organisations. As part of the negotiations with financiers, organisations not only consider how the funding arrangements will meet their financing requirements but also how the terms may help them achieve their ESG objectives.



Accounting requirements

The additional complexity in the accounting for financing that incorporates ESG measures may require organisations to set up new accounting policies and processes for these new arrangements. This includes considering the relevant additional disclosures to include in the financial statements.



Reporting your ESG story

Reporting on the ESG story is much broader than what is captured in the financial report. Organisations consider the applicable reporting frameworks and how sustainability financing fits into the framework. For some organisations, this includes establishing their ESG goals and objectives and reporting against them.



Assurance reporting

Stakeholders increasingly want assurances over an organisation's ESG performance. Assurance plays an important role in building trust around the robustness of non-financial information including ESG measures. Organisations consider the systems and processes to enable them to report on their ESG goals and targets.

Appendix - technical basis



Supply chain financing

In response to investors' calls for more transparency of the impact of supplier finance arrangements on the financial statements, the International Accounting Standards Board (the Board) is proposing additional disclosure requirements for companies that enter into these arrangements. The Board proposes amending IAS 7 (AASB 107) *Statement of Cash Flows* and IFRS 7 (AASB 7) *Financial Instruments: Disclosures*.

For more information refer to our [web article](#).

AASB 9 *Financial Instruments* – relevant guidance

B5.4.5 For floating-rate financial assets and floating-rate financial liabilities, periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate. If a floating-rate financial asset or a floating-rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or the liability.

B5.4.6 If an entity revises its estimates of payments or receipts (excluding modifications in accordance with [paragraph 5.4.3](#) and changes in estimates of expected credit losses), it shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows. The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with [paragraph 6.5.10](#). The adjustment is recognised in profit or loss as income or expense.

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