

ESG FEATURES IN FINANCIAL INSTRUMENTS: A CHALLENGE FOR THE ACCOUNTING TREATMENT

Sabrina Pucci^{*}, Marco Venuti^{*}, Umberto Lupatelli^{*}

^{*} Department of Business Studies, Roma Tre University, Rome, Italy



How to cite: Pucci, S., Venuti, M., & Lupatelli, U. (2022). ESG features in financial instruments: A challenge for the accounting treatment. In G. M. Mantovani, A. Kostyuk, & D. Govorun (Eds.), *Corporate governance: Theory and practice* (pp. 52–56). <https://doi.org/10.22495/cgtapp8>

Received: 03.05.2022
Accepted: 09.05.2022
Keywords: Financial Reporting, Financial Instrument, Impairment, ESG

Copyright © 2022 The Authors

JEL Classification: M14, M41, M48
DOI: 10.22495/cgtapp8

Abstract

The volume of financial instruments including environmental, social, and governance (ESG) features is rapidly increasing with a result that the scale of the issue continues to increase in the lack of a specific accounting rule. This situation creates a deep debate referring to the possibility of financial instruments with an ESG factor to pass the solely payments of principal and interest (SPPI) test according to the current requirements in International Financial Reporting Standards (IFRS) 9. The debate is not only present in Europe but also in the US. The current accounting standards are not able to define a unique accounting solution for instruments that incorporate ESG factors and when these factors are material for the market, it is not clear which may be the proper solution to present them in the financial statements. The main issue is if it needs to separate ESG features from the basic financial instruments. Existing different positions on this issue, European Financial Reporting Advisory Group (EFRAG) proposed to International Accounting Standards Board (IASB) the introduction of more guidance and examples to apply in a consistent way the current provisions set forth by IFRS 9. In a dynamic market characterized by strong growth and the introduction of new complex instruments, the solution proposed by the EFRAG appears minimal. The introduction of a specific section of IFRS 9 addressed to this issue may be more

appropriate in the light of the existing attention on the ESG features disclosure and the possibility to provide specific metric that permits measurement of the ESG features separately from the basic lending instrument.

1. THE FRAMEWORK AND THE LITERATURE

The accounting treatment of environmental, social, and governance (ESG) features joined with a financial instrument or an insurance contract constitutes today an important topic of discussion. International Financial Reporting Standards (IFRS) 9 doesn't provide an explicit way to evaluate financial instruments that considers ESG factors as IFRS 17 doesn't consider in an explicit way the ESG features and their impact on insurance contracts.

This situation creates a deep debate referring to:

- the possibility of a financial instrument with an ESG factor to pass the solely payments of principal and interest (SPPI) test following the current IFRS standard;

- if the ESG feature should be considered separately;
- if the ESG feature cannot be separated because of the minimum impact on future cash flows;
- if the ESG feature may be considered as part of credit risk or of profit margin.

The different solution adopted may influence the presentation of the instruments and their economic impact on financial statements with a lack of comparability between entities on an aspect that is becoming day after day ever more important in the investment decision-making processes.

The debate is not only present in Europe but also in the US.

The Sustainability Accounting Standard Board (SASB) in some of its standards regarding the financial sector affirms the necessity to incorporate environmental, social and governance factors in credit risk analysis and the joined qualitative and quantitative disclosure: “*ESG trends include, but not limited to, climate change, natural resource constraints, human capital risks and opportunities and cybersecurity risk*” (SASB, 2018, para. 7.1).

Some papers examined the question from another point of view considering the impact of ESG disclosure and of the new standards that emphasize the ESG materiality on the market reactions reaching some interesting conclusions (Schaltegger & Burritt, 2006; Spandel, Schiemann, & Hoepner, 2020; Koroleva, Baggieri, & Nalwanga, 2020; Kumar & Firoz, 2022).

So, if the current accounting standards are not able to define a unique accounting solution for instruments that incorporate ESG factors and these factors are materials for the market which can be

the proper solution to present them in the financial statements? Is it necessary or not to separate them from the basic financial instruments?

These are the questions with which this paper would like to contribute to the current debate considering in the response both the general architecture of the accounting standards and the not current homogeneous requirements for non-financial information¹.

2. THE ICMA GUIDELINES IN REPORTING SOCIAL AND GREEN BOND. THE TENTATIVE DECISIONS OF IASB AND THE EFRAG POSITION

Obviously, it is very complex to define an accounting standard when the instruments are not standardized. For this reason, two initiatives of the International Capital Market Association (ICMA) are very interesting: The green bond principles and the social bond principles issued in June 2021 (ICMA, 2021a, 2021b). Both guidelines present the types of green bonds and social bonds existing on the market and give attention to the reporting process. In detail, the issuer should prepare an annual report in which "*transparency is a particular value in communicating the expected and/or achieved impact of project*" (ICMA, 2021a, para. 4, p. 6). The use of qualitative and quantitative indicators and performance measures is encouraged and described in a specific ICMA handbook (ICMA, 2020) and these indicators may be the basis for the evaluation of the impacts of the ESG features on the accounting of the bonds. Obviously, these standards are completely voluntary and these create a non-homogenous basis for the analysis of the proper accounting method.

IASB and EFRAG are doing some important analysis on this topic: IASB in a paper of April 2022 affirms that "*the SSPI requirement is an appropriate basis to determine whether a financial asset with a ESG linked features is measured at amortised cost or fair value through profit or loss*" (IFRS, 2022, para. 32). However, an application guidance that permits a consistent application of SPPI conditions may be useful. This guidance should clarify: the characteristics of basic lending, which variability of cash flows may be considered consistent with the SPPI test, in what way the disclosure could be implemented in the case of existence of ESG factors and how these factors influenced risk.

EFRAG in its comment letter (EFRAG, 2022) to post implementation document on IFRS 9 classification and measurement issued by IASB evidences its willingness to contribute to finding a solution on the ESG features topics in presence of different position of different stakeholders on these topics.

¹ For listed companies an interesting point of reference may be constituted by ICMA (2021a) and ICMA (2021b).

3. THE POSSIBLE SOLUTIONS

A specific analysis carried out from the EFRAG indicates that a financial instrument with common ESG features can only pass the SPPI test, if either:

- The ESG features represent clauses excluded from the SPPI test variability in cash flows being clauses that do not contain leverage and that are related to a non-financial variable specific to the borrower.
- The ESG feature only has a *de minimis* effect on the contractual cash flows. This approach is the most widely used. It moves from the idea that the contractual feature has a ‘*de minimis*’ effect on the contractual cash flows of a financial asset and thus an immaterial impact.
- The ESG feature can be considered a consideration for credit risk consistent with a basic lending arrangement.
- The ESG feature can be considered a part of the profit margin consistent with a basic lending arrangement.
- The ESG feature is to be separated from the basic lending instrument applying a specific accounting policy.

The circumstance that there are different opinions regarding the “if” and “way” a financial instrument can pass the SPPI test, it is evident that the accounting of financial instruments with ESG features is an accounting priority to face in a short time. EFRAG proposed to solve that issue by introducing specific guidance on ESG-linked financial instruments considering that more guidance and examples could help to drive greater consistency of application.

However, taking into consideration that the amount and the complexity of the financial instruments with ESG features issued on the financial market have strong development, the EFRAG proposal may be not enough. The current situation is that the volume of financial instruments including ESG features is rapidly increasing with a result that the scale of the issue continues to increase in the lack of a specific IASB accounting rule. The ESG features linked to financial instruments were not present when IFRS 9 was developed and, consequently, there is not any specific guidance to apply.

A regulation based on the different kinds of ESG-linked financial instruments may be an appropriate solution. Following this approach, the IASB may introduce, in a specific section of IFRS 9, the new specific regulation for the different kinds of instruments taking also in consideration their characteristics and the purpose of portraying the economics of the ESG transactions and their difference compared to financial instruments focus only on the typical financial risks.

A compulsory specific disclosure regarding the ESG features represents a put the users in the condition to understand and compare the different instruments issued by the companies.

In addition, the separation of the ESG features from the basic lending instruments may permit to provide also quantitative

information, in addition to the specific disclosure to provide in the notes to the financial statements, on the ESG feature encouraging the comparability of the accounting data. This solution would require specific preliminary analysis of the appropriate metrics to measure the different ESG features existing on the market. The result of this analysis would represent an important evolution in the accounting model adopted usable also, for further purposes, in the sustainability reporting.

REFERENCES

1. European Financial Reporting Advisory Group (EFRAG). (2022, January 28). *EFRAG's final comment letter in response to the IASB request for information on the post-implementation review of IFRS 9 — Classification and measurement*. Retrieved from <https://www.efrag.org/News/Project-563/EFRAgs-Final-Comment-letter-in-response-to-the-IASB-Request-for-Information-on-the-Post-implementation-Review-of-IFRS-9---Classification-and-Measurement>
2. International Capital Market Association (ICMA). (2020). *Handbook: Harmonized framework for impacting reporting*. Retrieved from <https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/Handbook-Harmonized-Framework-for-Impact-Reporting-December-2020-151220.pdf>
3. International Capital Market Association (ICMA). (2021a). *Green bond principles: Voluntary process guidelines for issuing green bonds*. Retrieved from <https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Green-Bond-Principles-June-2021-140621.pdf>
4. International Capital Market Association (ICMA). (2021b). *Social bond principles: Voluntary process guidelines for issuing social bonds*. Retrieved from <https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Social-Bond-Principles-June-2021-140621.pdf>
5. International Financial Reporting Standards (IFRS). (2022). *Contractual cash flow characteristics assessment — ESG-linked features* (IASB Meeting Agenda Ref. 3B). Retrieved from <https://www.ifrs.org/content/dam/ifrs/meetings/2022/april/iasb/ap3b-ccfc-esg-linked-features.pdf>
6. Koroleva, E., Baggieri, M., & Nalwanga, S. (2020). Companies performance: Are environmental, social and governance factors important? *International Journal of Technology*, 11(8), 1468–1477. <https://doi.org/10.14716/ijtech.v11i8.4527>
7. Kumar, P., & Firoz, M. (2022). Does accounting-based financial performance value environmental, social and governance (ESG) disclosures? A detailed note on a corporate sustainability perspective. *Australasian Accounting, Business and Financial Journal*, 16(1), 41–72. <https://doi.org/10.14453/aabfj.v16i1.4>
8. Schaltegger, S., & Burritt, R. L. (2006). Corporate sustainability accounting: A nightmare or a dream coming true? *Business Strategy and the Environment*, 15(5), 293–295. <https://doi.org/10.1002/bse.537>
9. Spandel, T., Schiemann, F., & Hoepner, A. G. F. (2020). *Capital market reactions to ESG materiality classifications*. <https://doi.org/10.2139/ssrn.3694285>
10. Sustainability Accounting Standard Board (SASB). (2018). *Commercial banks, sustainability accounting standard*. Retrieved from SASB website: www.sasb.org/standards