The Role of Assurance in Sustainable Financing

Sustainable financing has seen remarkable growth in recent years as companies seek to align financial and business objectives with sustainability strategies. New issuances of green, social, and sustainability bonds, for example, have grown from less than $100 billion in 2014 to nearly $1 trillion in 2023.[1]

As sustainable financing becomes a more popular means of raising capital to further sustainability strategies, companies should understand the importance of assurance in the financing lifecycle.

In this article, we provide an overview of sustainable financing, lay out the typical journey for a company during a sustainable financing issuance, and share considerations for assurance as a critical aspect of raising this form of capital.

1 Bloomberg, "Green bonds reached new heights in 2023," Accessed Mar. 29, 2024,

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- Looking for an Advantage? Focus on Internal Controls for ESG
- Managing your ESG Data Toward Third-Party Assurance
- The Role of Assurance in Sustainable Financing

What is Sustainable Financing?

Sustainable financing is an umbrella term to address multiple means of raising capital to pursue environmental and/or social objectives. Categories include debt instruments such as bonds or loans. Common examples of sustainable financing include:

- **Green Bonds/Loans** are debt instruments where the net proceeds are allocated to finance and/or refinance "Green Projects." Green Projects contribute to environmental-related objectives, including investments in projects and assets in categories such as renewable energy, energy efficiency, pollution prevention, clean transportation, and the circular economy. Green bonds and associated bond offering documentation typically align with the Green Bond Principles (GBP) developed by the International Capital Market Association (ICMA). Similarly, green loans and associated credit agreements typically align with the Green Loan Principles (GLP) developed by the Asia Pacific Loan Market Association (APLMA), Loan Market Association (LMA), and Loan Syndications and Trading Association (LSTA).
- **Social Bonds/Loans** are debt instruments where the net proceeds are allocated to finance and/or refinance "Social Projects." Social Projects contribute to social-related objectives, including investments in projects and assets in categories such as affordable housing, access to essential services, and socioeconomic advancement and empowerment. Social bonds and associated bond offering documentation typically align with the Social Bond Principals (SBP) developed by ICMA. Similarly, social loans and associated credit agreements typically align with the Social Loan Principles (SLP) developed by the APLMA, LMA, and LSTA.
- **Sustainability Bonds/Loans** combine characteristics of both green and social bonds and loans.
- **Sustainability-Linked Bonds and Loans** are debt instruments where the interest or coupon rate is linked to sustainability performance targets established by the issuer (bonds) or borrower (loans), often in accordance with ICMA's Sustainability-Linked Bond Principles (SLBP) or Sustainability-Linked Loan Principles (SLLP) developed by the APLMA, LMA, and LSTA. Meeting the targets by a specified date generally decreases the issuer's or borrower's interest payments, whereas missing the targets may increase them. An example of a target would be pledging to use a certain percentage of recycled water in a manufacturing process. Note, the use of proceeds from sustainability-linked bonds or loans typically are not restricted to green or social projects as with green, social, and sustainability bonds and loans.

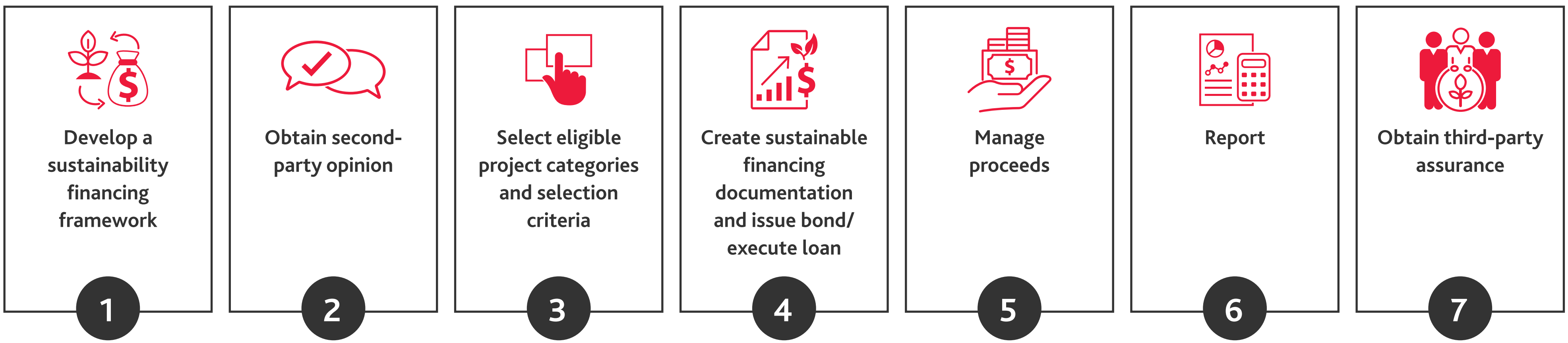
Hereinafter, the GBP, GLP, SBP, SLP, and SLBP are referenced as the "Principles".

The Sustainable Financing Journey

Whether issuing a use of proceeds sustainability bond/loan or sustainability-linked bond/loan, a standard set of steps can be followed to help ensure a smooth and successful issuance process. Refer to the following sections for details pertaining to the various steps for each type of financing and the timing of each step.

USE OF PROCEEDS SUSTAINABILITY BOND CRITICAL STEPS

Figure 1: The Green, Social and Sustainability Bond/Loan Journey



1. Develop a Sustainability Financing Framework

As a best practice, companies with green, social, and sustainability financings typically begin their journey with the development of a sustainability financing framework. Generally, a sustainability financing framework details the background of the company, purpose of the framework, the company's broader sustainability goals, nature of financing activities subject to the framework, and the process by which the issuer/borrower intends to use proceeds from green, social, and sustainability financing.

While the development of a sustainability framework is optional, it is an ICMA-recommended step and considered to be best practice to communicate a company's sustainability goals to prospective investors. It also provides an opportunity for companies to link the widely accepted Principles to their own sustainability strategies.

A typical sustainability financing framework includes the following components, in alignment with the relevant Principles:

- **Use of proceeds:** Designates eligible project categories, including selection criteria, to which proceeds from financing activities (e.g., bond issuance and loans) can be allocated for financing (or refinancing) of eligible projects
- **Project selection processes:** Describes a company's internal processes and controls for determining project eligibility and selecting projects to which proceeds from sustainable financing activities will be allocated
- **Management of proceeds:** Details the processes and controls for managing and tracking the proceeds from issuances or loans, including both used and unused portions of proceeds, throughout the financing term
- **Reporting:** Details how the use of proceeds will be evaluated and reported throughout the financing term, including internal reviews and external assurance
- **External Reviews:** Describes the types of external reviews to be performed both pre-issuance (i.e., second party opinion) and post-issuance (i.e., third-party attestation/verification)

Sustainability financing frameworks are generally made readily accessible to investors through posting to the company's externally facing website (e.g., their investor relations or sustainability web pages).

2. Obtain second-party opinion

Issuers/borrowers typically engage a service provider to provide a second party opinion (SPO) over the company's sustainability bond framework. As a part of the SPO process, the SPO service provider assesses the framework for alignment with the relevant Principles.

SPOs can be performed either on sustainability frameworks or on an individual financing. In today's environment, companies tend to obtain an SPO on their frameworks as it reduces the need to engage a third-party provider for each individual issuance/loan.

Obtaining a SPO is optional. When obtained, it is typically referenced within financing documentation and enhances the bond or loan marketability because it signals to the investors/creditors that the proceeds will be used in accordance with internationally recognized Principles.

3. Select Eligible Project Categories and Selection Criteria

Within sustainable financing documentation (e.g., prospectus, prospectus supplement, pricing supplement, offering memorandum, credit agreement) and specifically, the "Use of Proceeds" section within such documentation, companies select and include the eligible project categories and associated criteria for selecting projects to which proceeds from the issuance will be allocated.

If issuers have a sustainability financing framework, they can elect to include all, or a subset, of eligible project categories and project selection criteria from the framework within bond offering documentation.

4. Create Sustainable Financing Documentation and Issue Bond/Execute Loan

After eligible project categories and associated criteria have been selected, companies create the bond offering documentation, inclusive of elements similar to a standard bond issuance, or begin tailoring the credit agreement in the case of loans. Within the "Use of Proceeds" section, which is often included within bond offering/credit agreement documentation, companies will include the project categories and criteria selected.

In addition, the "Use of Proceeds" section — similar to a financing framework as detailed above — will often include the following subsections:

- Project selection processes
- Management of proceeds
- Reporting
- External Reviews

Green, social, and sustainability bonds are issued following the same protocol as standard bonds. Similarly, green, social, and sustainability loans are executed following the same protocol as standard credit facilities.

5. Manage Proceeds

After issuance or loan execution, companies begin managing the net proceeds from the bond/loan. For bonds, the amount of proceeds available for allocation to eligible projects is typically the proceeds net of issuance costs (i.e., underwriting fees and legal fees). To manage proceeds, companies should formally track both the portions of net proceeds that have been allocated to eligible projects and unused portions of proceeds. Proceeds can be tracked and managed on a financing-by-financing basis or for multiple financing opportunities if a particular company has more than one outstanding green, social, or sustainability financing.

6. Report

Until net proceeds from a given green, social, or sustainability financing are fully allocated, companies should periodically report to security holders the amounts of net proceeds allocated to eligible projects and the categories of projects to which proceeds have been allocated as well as descriptions of example projects/expenditures to which proceeds have been allocated. It is common for such reporting to be performed on a quarterly or annual basis. Such reports are also often referenced as "Impact Reports," as their intended purpose is to drive transparency regarding the green and/or social impact of projects to which proceeds have been allocated.

7. Obtain Third-Party Assurance

Within a period of time after a given issuance, typically a year, issuers are usually required to engage a third-party (e.g., a public accounting firm) to provide reasonable assurance over whether or not the issuer will (or has) allocated proceeds from the financing in accordance with the terms set forth in the sustainable financing documentation. The independent accountant's report can be published independently and made available to investors/creditors on the company's website or included within a broader Impact Report.

Refer to the **Considerations for Assurance** section below for insights on preparing for third-party assurance.

Companies may benefit by engaging a third-party to conduct an assurance "readiness assessment" prior to their first sustainable financing. These assessments aid the company in preparing for the third-party assurance process, including collating the necessary evidence supporting the tracking and allocation of proceeds from a given sustainable financing.

SUSTAINABILITY-LINKED BOND/LOAN CRITICAL STEPS

Figure 2: The Green, Social and Sustainability-Linked Bond/Loan Journey

1. Select key performance indicators
2. Calibrate sustainability performance targets
3. Determine bond characteristics
4. Obtain second-party opinion
5. Create bond offering documentation and issue bond
6. Report
7. Obtain third-party assurance

1. Select Key Performance Indicators

Companies begin the process of issuing a sustainability-linked bond (SLB) or sustainability-linked loan (SLL) by taking inventory of their broader sustainability goals and then selecting one or more key performance indicators (KPIs) to measure progress against such goals. As indicated in the SLBP, issuers are encouraged to select KPIs that are recognizable to potential investors of the bond (e.g., from annual reports and sustainability reports) and creditors of loans to allow such investors and creditors to evaluate performance of historical performance against KPIs. Further, selected KPIs should be measurable and verifiable as to allow an independent party to objectively verify progress.

2. Calibrate Sustainability Performance Targets

After KPIs have been selected, issuers define one or more sustainability performance targets (SPTs) per KPI to allow for measurement of progress against each KPI. SPTs should aim for material progress against KPIs and specifically detail established baselines and timelines for achievement.

3. Determine Bond Characteristics

Once KPIs and associated SPTs have been established, companies define the structural characteristics of the bond/loan that are tied to the achievement of SPTs. This could include variable interest rates to be paid on outstanding principal amounts dependent on whether SPTs are achieved or missed.

4. Obtain Second-Party Opinion

Like use of proceeds bonds, on a pre-issuance or loan execution basis, companies typically engage a service provider for a second party opinion (SPO). However, in the case of SLBs and SLLs, the SPO provider typically provides an opinion on a financing-by-financing basis (versus on an overall framework) to address a given financing's alignment with the SLBP, including reasonableness of KPIs, SPTs, and established baselines associated with SPTs.

As mentioned above, obtaining a SPO is optional. However, when obtained, it enhances the bond's marketability, as it signals to the investors that the proceeds will be used in accordance with the internationally recognized Principles.

5. Create Bond Offering Documentation and Issue Bond

After KPIs and SPTs have been established, companies create the bond offering or loan documentation, inclusive of elements of a standard bond issuance or loan agreement. The documentation should clearly detail KPIs, SPTs, and bond characteristics linked to the measurement of KPIs against SPTs. SLBs are issued following the same protocol as standard bonds.

6. Report

On a periodic basis, at least annually, companies should publish a report in which the achievement of SPTs is measured for a period that is relevant for the potential adjustment of characteristics associated with the bond/loan (e.g., interest rate adjustment). The report, at minimum, should be made available to stakeholders in the measurement KPIs against SPTs (i.e., bondholders for bonds, lenders for sustainability linked loans).

7. Obtain Third-Party Assurance

Issuers should seek a third-party (e.g., a public accounting firm) to provide limited assurance over the measurement of KPIs against SPTs. Such verifications should be performed on a periodic basis in alignment with dates associated with the achievement of SPTs. The independent accountant's report can be published independently and made available to bondholders or creditors on a company's website or included within a broader report.

Third-party assurance is typically a necessary component of an SLB or SLL and a condition of any structural component (e.g., interest rate) of an SLB or SLL being modified.

Refer to the **Considerations for Assurance** section below for insights on preparing for third-party assurance.

First-time SLB issuers or SLL borrowers may benefit by engaging a third-party to conduct an assurance readiness assessment prior to issuance or loan execution to help ensure the company will be prepared to provide sufficient evidence supporting the measurement of KPIs against SPTs.

Considerations for Assurance

Third-party assurance is a highly recommended and often required aspect in the life cycle of green, social, sustainability, and sustainability-linked bond/loan issuances. It not only enhances the marketability of a security, but also fosters trust with and transparency for investors. As you near the assurance phase of a sustainability financing, there are a few considerations and challenges to understand and be aware of, as presented below.

CONSIDERATION	GREEN, SOCIAL, AND SUSTAINABILITY BOND FINANCING	SUSTAINABILITY-LINKED FINANCING
Processes and Controls	Prior to the issuance/execution of green, social, and sustainability financing, processes and controls should be designed to track proceeds from financing activities. This includes creating a process(es) and control(s) to track proceeds using a ledger and to require review and approval of the use of proceeds prior to allocation to verify the use of proceeds meets the applicable criteria. Post-issuance, issuers/debtors should ensure related processes and controls are implemented and operating effectively.	Prior to the issuance/execution of sustainability-linked financing, processes and controls should be designed and implemented to periodically track progress against SPTs. This includes ensuring appropriate and sufficient data is available and reviewed to verify progress. Post-issuance, issuers/debtors should ensure related processes and controls are implemented and operating.
Management Assertion	The start of the assurance process begins with management drafting an assertion (“Management Assertion”) regarding its allocation of proceeds from a green, social, or sustainability financing. The Management Assertion states the amount of proceeds allocated as of a point in time, the types of green and/or social projects to which proceeds were allocated, and the criteria used by management in determining the eligibility of each project. Typically, the types of projects and related criteria included in a Management Assertion mirror the types of projects and related criteria included within the related bond offering or credit agreement documentation. It is important that the criteria include the characteristics of being relevant, objective, measurable, and complete as per the attestation standards prescribed by the American Institute of Certified Public Accountants (“AICPA”) and under which the assurance engagement is performed. Often, this means including criteria and definitions supplemental to the criteria included within bond offering or credit agreement documentation.	The start of the assurance process begins with management drafting an assertion (“Management Assertion”) regarding its achievement of SPTs at a particular measurement date. The Management Assertion states relevant KPIs and SPTs, associated baselines, and measurement of relevant KPIs. The KPIs and SPTs included in management's assertion should correlate directly to KPIs and SPTs in the related bond offering or loan documentation.

CONSIDERATION	GREEN, SOCIAL, AND SUSTAINABILITY BOND FINANCING	SUSTAINABILITY-LINKED FINANCING
Third-Party Assurance Deliverable & Level of Assurance	The third-party assurance deliverable is an Independent Accountant's Report in which the assurance provider provides **reasonable assurance** about whether Management's Assertion is fairly stated, in all material respects. The type of attestation performed by the assurance provider is an examination performed in accordance with the attestation standards set forth in AT-C sections 105 and 205 as established by the AICPA. The Independent Accountant's Report can be "general use," meaning the report is not restricted to specified parties or "restricted use," meaning the report should only be distributed to and used by specified parties. Independent Accountant's Reports resulting from bond issuances tend to be general use whereas Independent Accountant's Reports resulting from green, social, or sustainable loans tend to be restricted to parties to the related credit agreements. Lastly, the Independent Accountant's Report can be published/provided independently of other reporting, or be included within other reporting (i.e., Impact Report).	The third-party assurance deliverable is an Independent Accountant's Report in which the assurance provider provides **limited assurance** regarding whether any material modifications should be made to Management's Assertion in order for it to be fairly stated. The type of attestation performed by the assurance provider is a review conducted in accordance with attestation standards set forth in AT-C sections 105 and 210 as established by the AICPA. The Independent Accountant's Report can be "general use," meaning the report is not restricted to specified parties or "restricted use," meaning the report should only be distributed and used by specified parties. Independent Accountant's Reports resulting from sustainability-linked bond issuances tend to be general use whereas Independent Accountant's Reports resulting from sustainability-linked loans tend to be restricted to parties to the related credit agreements. In most cases, reporting and third-party assurance is required to benefit from adjustments to the sustainability-linked financing's financial and/or structural characteristics. Lastly, the Independent Accountant's Report can be published/provided independently of other reporting or be included within other reporting that provides additional details of performance of KPIs and related baselines. The goal of such reporting is to maximize transparency for investors.
Data	A critical aspect of a successful assurance engagement is understanding the nature of data (i.e., evidence) that will be required to support a Management Assertion. Specifically, it is important for issuers/debtors of sustainable financing to inventory the types of source data needed to verify that the expenses or investments to which proceeds from sustainable financing are allocated meet the applicable criteria. Third-party assurance providers typically require data generated or executed by parties independent of the sustainable financing issuer/debtor (e.g., contracts with third parties, invoices from third parties, bank statements) to verify the fair presentation of a Management Assertion.	Similar to green, social, and sustainable financing, a critical aspect of a successful assurance engagement relevant to sustainability-linked financing is understanding the nature of evidence that will be required to support a Management Assertion. Specifically, it is important to understand the types of third-party data required to measure and calculate KPIs. This can become increasingly challenging when collecting data across a larger organization with multiple reporting business units that may have differing methodologies and data to calculate KPIs.

CONSIDERATION	GREEN, SOCIAL, AND SUSTAINABILITY BOND FINANCING	SUSTAINABILITY-LINKED FINANCING
Timing	Issuers/debtors of green, social, and sustainable financings should understand contractual requirements to provide/publish third-party assurance reports (i.e., Independent Accountant's Report) and plan accordingly. For example, bond offering documentation often stipulates that the issuer will make a third-party assurance report available within one year of issuance. It is not uncommon for first-time issuers to underestimate the amount of time required for third-party assurance providers to complete an examination, which could lead to a default event or breach of obligation.	Issuers/debtors of sustainability-linked financing should understand relevant KPI measurement dates and the impact of achieving (or missing) the related SPTs. As important, issuers/debtors of sustainability-linked financings should understand stipulated timelines to provide a third-party assurance provider in order for related structural changes to be realized (e.g., reduced interest rate).

BDO publishes insights on an ongoing basis to help companies understand how to navigate the ESG assurance landscape. Executives are encouraged to follow this series for comprehensive, value-added insights on the ESG environment.

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