

Identifying natural capital risk and materiality

IASB: Conceptual Framework Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.

Global Reporting Initiative: G4 Reporting Guidelines Relevant topics are those that may reasonably be considered important for reflecting the organisation’s economic, environmental and social impacts, or influencing the decisions of stakeholders, and, therefore, potentially merit inclusion [in reporting].

- Could the definition and understanding of the concept of materiality be evolving to incorporate new issues, inclusive of more stakeholders, and over greater time horizons?
- To what extent are various standard setters and other bodies developing their frameworks to incorporate new forms of the materiality principle – and what challenges does this bring?
- In light of developments, are the issues and risks related to natural capital more likely to be included as material business concerns?

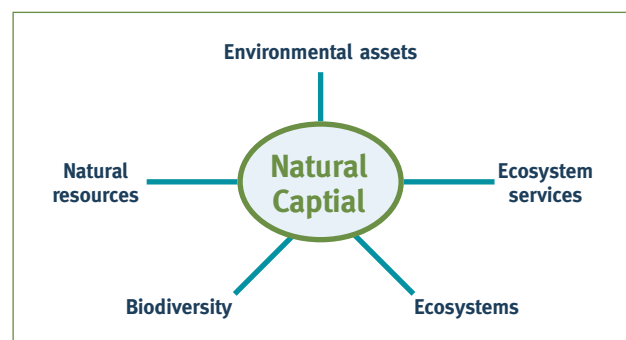
What is the challenge?

When a sample of different definitions of materiality is studied, there is an obvious distinction in three key areas: **scope** (the range of information covered), **stakeholder groups** (those whose perceived interests are likely to be affected) and **time frame** (the time period applied). These variables are important in that they define the boundaries of materiality decisions made by organisations. Depending on which definition is used, the issues and risks included in corporate reporting and decision making may extend to include a range of economic, social, environmental or governance issues not previously considered. For example, not all the issues that would be deemed material to an entity’s neighbouring communities over a long period may be considered material to mainstream investors over a short time frame of one or two years.

New issues for consideration

One of the issues that businesses are starting to recognise as a risk to be managed is natural capital – ‘the stock of natural ecosystems that yields a flow of valuable ecosystem goods or services’.¹ Box 1 summarises some of the issues and terms related to/associated with natural capital (which are defined in the Glossary). Recent analysis estimates that global primary production and processing sectors generate unaccounted costs of \$7.3 trillion a year – roughly 13% of global economic output in 2009 – through their environmental impacts and unsustainable use of natural resources.²

Box 1: Terms associated with natural capital





The Changing Materiality Lens:

With many of the ‘traditional’ standard setters, and other bodies, defining material issues for organisations as those primarily relating to ‘economic decisions’, the boundaries of materiality may seem restricted to concerns that affect only investors and shareholders. In practice, ‘economic decisions’ could well be interpreted as also including the economic choices of other stakeholders such as employees, customers and communities – important groups who also have specific economic interests in organisations (e.g. when assessing whether to work for, or purchase from, an entity).³

Sustainable business network BSR has commented that some bodies involved in the design and implementation of sustainability reporting frameworks ‘diverge in their approach based on which stakeholder group they focus their initiative on’ – whether investors, regulators or wider stakeholder groups. They suggest that this variability affects the ‘materiality lens’ by which issues and concerns are deemed significant and relevant to a particular organisation.⁴

Evolving interpretations of materiality affect the boundaries of materiality assessments; hence the key areas of scope, stakeholders and time frames vary depending on the definition of materiality employed by an organisation.⁵

The changing boundaries of materiality are likely to enhance the interest in and justification for natural capital’s consideration in corporate materiality assessments in relation to the three key areas:

- the **scope** of issues that are material broadening to the environmental and social impacts of organisations, including those related to natural capital
- the **stakeholder groups** to be included when assessing if an issue is material, extending to bodies such as NGOs and local communities that are concerned about natural capital issues
- the **time frame** over which business impacts are considered material, incorporating previously unaccounted medium- and long-term impacts and effects on natural capital issues.

Materiality definitions and analysis

ACCA, KPMG in the UK, and FFI have identified and analysed definitions of materiality from a range of regulators, standard setters and sustainability reporting bodies to compare and contrast their different perspectives. Table 1 presents a number of these definitions, and colour codes those terms that relate specifically to the key aspects of **scope**, **stakeholder groups**, and **time frame**.

Table 1: Materiality definitions used by some key standard setters and bodies

Body	Definitions of materiality (with colour coding of scope , stakeholder groups and time frames highlighted)
IASB & FASB	Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. ⁶
IFAC/ IAASB	Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence relevant decisions of intended users taken on the basis of the subject matter information. The practitioner’s consideration of materiality is a matter of professional judgment, and is affected by the practitioner’s perception of the common information needs of intended users as a group . ⁷
FRC	Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. ⁸
SEC	Information is material if “there is a substantial likelihood that a reasonable shareholder would consider it important” in making an investment decision. To fulfill the materiality requirement, there must be a substantial likelihood that a fact “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” ⁹ A matter is “material” if there is a substantial likelihood that a reasonable person would consider it important. ¹⁰
GRI 3.1	Materiality for sustainability reporting is not limited only to those sustainability topics that have a significant financial impact on the organisation. Determining materiality for a sustainability report also includes considering economic, environmental, and social impacts that cross a threshold in affecting the ability to meet the needs of the present without compromising the needs of future generations . ¹¹
GRI G4	Organisations are faced with a wide range of topics on which they could report. Relevant topics are those that may reasonably be considered important for reflecting the organisation’s economic, environmental and social impacts , or influencing the decisions of stakeholders , and, therefore, potentially merit inclusion in the report. Materiality is the threshold at which Aspects become sufficiently important that they should be reported. ¹²
IIRC	A matter is material if, in the view of senior management and those charged with governance, it is of such relevance and importance that it could substantively influence the assessments of the primary intended report users with regard to the organisation’s ability to create value over the short, medium and long term . ¹³ In determining whether or not a matter is material, senior management and those charged with governance should consider whether the matter substantively affects, or has the potential to substantively affect, the organisation’s strategy, its business model, or one or more of the capitals* it uses or affects. ¹⁴

* Forms of capital refer to the organisation’s resources and relationships and include financial, manufactured, human, intellectual, natural, and social and relationship capital



Grouping the definitions

While there are some obvious parallels and similarities in a number of these materiality definitions, it can be difficult to rank or order them definitively by a distinct variable or theme. As highlighted initially, there are apparent variations in the key areas of **scope**, **stakeholder groups** and **time frames** – from those that have an ‘economic’ focus to those that have wider boundaries. In particular, the aspects of **scope** and **stakeholder groups** offer quite clear boundaries for categorisation – and Figure 1 attempts to group the definitions detailed in Table 1 according to these two characteristics. Additionally, it highlights the two definitions that also incorporate **time frames**, and indicates the extent to which all the definitions might include natural capital (NC) issues within their boundaries.

Materiality and risk assessments in practice

In order to demonstrate how companies consider natural capital in their materiality and risk assessments in practice, the reports of 10 companies from sectors with a high impact on natural capital were reviewed (see Box 2). This section of the paper presents their overall performance, highlights good examples from the companies reviewed, and makes a number of recommendations on how accountants and finance professionals can better incorporate natural capital in their materiality and risk assessments.

Box 2: Companies reviewed

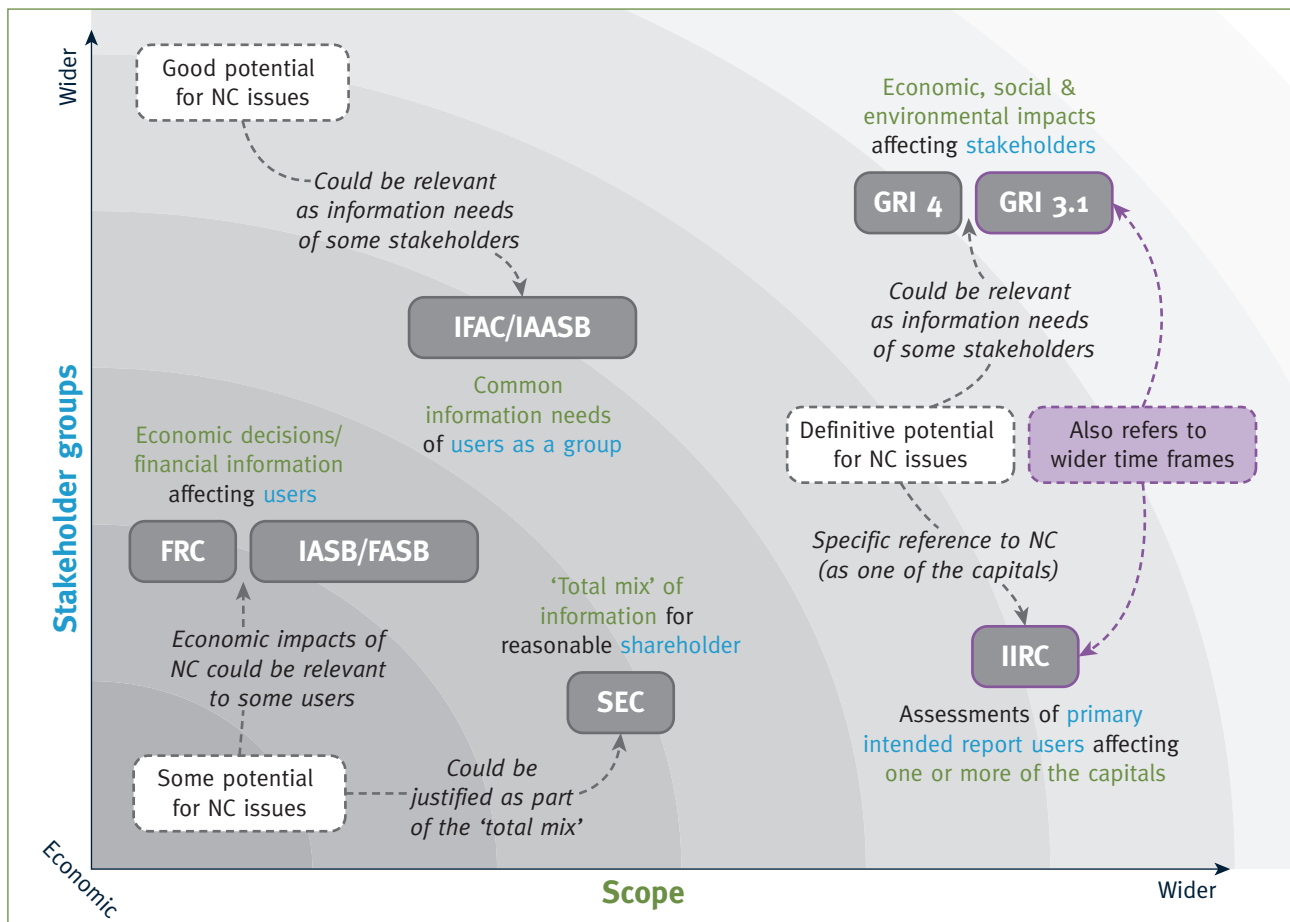
Sector	Company ^a	Annual Report	Sustainability Report
Farming	BRF Brasil	2012 ^b	
	Tyson Food Inc.	2012	2012
	Bunge	2012	2012
Forestry	SCA	2012	2012
	UPM	2012	Online
	Mondi	2012 ^c	2012
Construction	Larsen & Toubro	2011/12	2012
	Grupo ACS	2012	2012
Utilities	E.On	2012	2012
	Iberdrola	2012	2012

^a Companies initially part of an analysis in ACCA, FFI and KPMG’s ‘Is natural capital a material issue?’ report

^b Combined annual and sustainability report

^c Integrated report

Figure 1: Materiality definitions and their potential for identifying natural capital as a material issue



Materiality analysis and natural capital

A key aspect of the materiality principle is that information reported should be proportional according to a specific organisation. A company's materiality assessment determines what issues are addressed in its annual, integrated or sustainability reports, and transparency over the materiality definitions and processes applied allows the users of reports to understand how a company decided upon its material issues- both with regards to the nature of the issues, and whether they are proportionally reported on. This allows for users to judge as to whether the assessment was fit-for-purpose in terms of identifying the issues important to them, including natural capital.

Definition and explanation of materiality:

Company reports were reviewed to see whether or not reporters were defining and explaining materiality, as this forms the key starting point for understanding how companies identify material issues.

No companies provided a strict definition of materiality, but many of those reviewed included references to the GRI definition of materiality. A number of companies detailed the process of materiality assessment, and how they applied the process to identify key issues to address and report.

A good example is provided by Brazilian agribusiness, Bunge: 'Materiality is an item contained in a standard GRI Sustainability Report, which deals with subjects that help stakeholders consider and reach conclusions in terms of the economic, social and environmental performance of the organisation that is reporting.'

Use of tools:

The use of tools and guidelines when performing materiality assessments increases the comparability and credibility of a report, providing a systematic way for companies to identify matters to report.

All 10 companies reviewed used the GRI guidelines to produce their sustainability reports, although many of them did not disclose whether or not GRI guidelines were followed when identifying material issues. Three of the companies reviewed (Bunge, Larsen & Toubro, and UPM) also used the AccountAbility AA1000 Standards.

The use of tools is beneficial as it provides stakeholders with confidence that a standard process has been followed and it increases transparency on process and results for the companies that use the tool to report.

Stakeholder engagement:

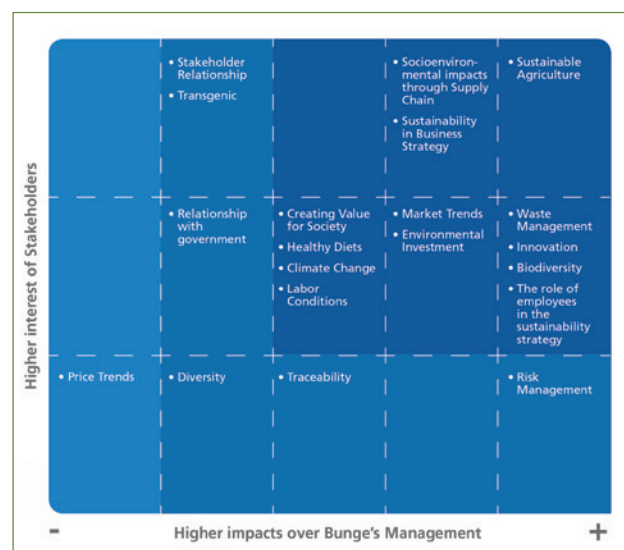
Engaging with stakeholders allows companies to assess the topics that are important to the groups they affect, and to tailor their reports accordingly. Being transparent about who was consulted allows readers to judge the range of views represented in the materiality assessment, and thus its completeness.

All companies reviewed provided details of their stakeholder engagement activities, but in many cases

these were not explicitly linked to their materiality process. Leading companies made this link very clear, presenting how stakeholder engagement feeds into their materiality assessments, usually in the form of a materiality matrix.

Bunge provides a good example of how stakeholder engagement has informed its materiality assessment. The company provides details of the stakeholder engagement process (panel discussions bringing together approximately 40 individuals representing the company's employees, customers, suppliers and investors, and relevant NGOs) and the results of the process, presented as a materiality matrix. As can be noted in the matrix, natural-capital-related issues of *sustainable agriculture* and *biodiversity* are identified.

Figure 2: Example of stakeholder engagement matrix



Source: Bunge Sustainability Report 2012 Edition, Brazil

Engaging with stakeholders during materiality assessments can lead to strategic opportunities and better-informed decision making by providing a focus and transparency for the stakeholder engagement process, identifying and prioritising issues specific to an organisation, and exploring new issues and the concerns of stakeholders.

Future generations:

Natural-capital-related issues can affect companies in the short, medium and long term. Therefore, a company taking a longer view when assessing its material issues will be more likely to identify natural capital as a material issue. In order to assess the period over which companies were considering their impacts, their materiality assessments and reports were reviewed for references to future generations.

The GRI G3 materiality definition includes a reference to recognising the needs of future generations when considering a company's material issues. Although none of the reports reviewed made specific references to future generations in their materiality assessments, all companies used the GRI guidelines to produce their sustainability reports, although it was not clear how closely some companies followed the GRI



materiality process. Four companies reviewed made reference to future generations elsewhere in their sustainability reports (Tyson Foods Inc., Bunge, E.On and Iberdrola).

Natural capital as a material issue:

Considering that all the companies reviewed operate in sectors with high impacts and dependencies on natural capital, reports were reviewed to determine whether or not natural capital had been identified as a material issue. This provided an indication of the quality of the materiality assessments.

All the reports reviewed identified environmental issues as material, although some gave only high-level, generic statements on the topic. Some companies went further, referencing natural-capital-related issues as material to their operations. For example, the US agribusiness Tyson Foods Inc. note that ‘conserving and protecting natural resources is essential to ensuring the minimization of our environmental foot print, the efficiency of our operations, and the availability of a clean and healthy environment for future generations’.

South African forestry company Mondi went further by stating in detail the range of key ecosystem services provided by forests, including the prevention of soil erosion and water run-off, breaking down pollutants, the provision of clean air and water, and climate regulation, among other services.

Conducting a robust materiality assessment that determines the specific natural-capital-related issues that an organisation affects and depends on can allow for better-informed decision making – by both the organisation and its stakeholders. It allows companies to link their activities to such issues (an important consideration when, for example, selecting a new site) and to set natural capital performance targets and goals, and it allows stakeholders to analyse how well management is managing impacts on natural capital and to compare one company with another in this respect.

Risk assessments and natural capital

In addition to undertaking materiality assessments to understand which issues are important to them, companies should consider whether such issues pose a long-term risk. As discussed, with the recognition of depletion of natural capital as a risk to be managed by business, the identification of natural capital issues in corporate reporting allows users to understand how an organisation intends to deal with such concerns.

Identification and exploration of natural capital as a long-term risk:

As a starting point in understanding whether organisations considered depletion of natural capital as a long-term risk, reports were assessed to identify whether natural capital issues are recognised in risk assessments, the process and stakeholders involved, and whether the organisation has measures in place to manage or mitigate such risks.

Few companies explicitly identified natural-capital-related matters as a long-term risk, instead making indirect references to the topic in their strategy and policy statements in their annual/ integrated reports. Notably, companies listed in the US have to file 10K forms with the SEC, and are required to include information on their key risks within their submissions. Through this process, certain natural capital risks are consequently discussed. As for the materiality assessment, all the companies reviewed conduct extensive stakeholder engagement. As with the materiality process, however, it can be difficult to ascertain whether or not such engagements are then specifically used as part of the risk-assessment process.

Brazilian agribusiness BRF Brasil link the natural capital risk associated with deforestation in the Amazon rainforest to risk in their supply chain: ‘In 2012, the Company expanded its Supplier Chain Monitoring Program precisely to identify and mitigate risk controlled by third parties, which although not under the direct management of the Company, may influence the business. These factors include, for example, discontinuing relationships with suppliers in breach of human rights or suppliers contributing to deforestation in the Amazon region...’

Tyson Foods Inc. relate natural capital risks to their operations, and consequently financial performance: ‘extreme weather, including droughts, floods, excessive cold or heat, hurricanes or other storms, could impair the health or growth of livestock or interfere with our operations due to power outages, fuel shortages, damage to our production and processing facilities or disruption of transportation channels, among other things. Any of these factors, as well as disruptions in our information systems, could have an adverse effect on our financial results.’

The process of identifying natural capital in risk assessments helps identify evolving risk-management issues related to natural capital that could affect an organisation’s operations, allowing the organisation to develop and prepare for such issues, and potentially identify opportunities for product or process development.

Strategy and governance that include natural capital:

Reports were reviewed to ascertain whether natural capital is considered as a strategic sustainability issue, and whether it is also recognised in the core business strategy. Additionally, internal governance structures were reviewed for their inclusion of natural capital issues, as an indication that associated risks would be examined and reacted to at a strategic level.

Almost all the sustainability strategies considered natural capital issues, some of which were also mentioned in the business strategy – with reference to issues such as biodiversity and water. Mondi specifically refer to natural capital in the context of business risk assessment.

In their annual report, Swedish consumer goods and pulp and paper company SCA describe a number of ‘driving forces’ and global risks that they recognise will affect the



organisation – and indicate their approaches to mitigating these. This includes certain issues and risks that are directly related to natural capital.

- ‘Forest management: Illegal logging and timber from controversial sources threaten the forests of the world and biological diversity... SCA has goals for both preservation of biological diversity and responsible use of wood raw material.’
- ‘Water shortage: The UN predicts that two-thirds of the world’s population may live in areas with water shortages in 2025. Access to water is critical for people, industries, agriculture and food production. A large proportion of SCA’s production processes are dependent on access to water. A great deal of focus is therefore placed on effective water consumption and purifying processes.’

While none of the companies reviewed had clear governance structures in place to manage natural-capital-related risks, all had some form of high-level panel to oversee sustainability risks, and such panels were generally overseen by the company CEO. It is fair to assume that natural-capital-related risks would be included within the remit of these panels – but this is not explicitly stated.

Strategic opportunities and benefits can arise from including natural capital in strategy and governance structures. By integrating natural capital into core business strategy and connecting it to other areas of business an organisation can begin to ‘future proof’ itself to mitigate risks and realise opportunities associated with the issues.

Recommendations

Following the review, a number of recommendations emerged. Companies should:

- define materiality in a way suited to the business model
- be transparent over the materiality process and how external guidelines or tools have been applied
- link stakeholder engagement processes to the identification of natural capital material issues, and explain how the former inform the risk-assessment processes
- specify which natural capital issues are material (e.g. biodiversity, water, etc.) to the organisation, and develop goals/strategies for how to manage these
- report on those natural capital issues that are material to the organisation in more detail
- connect identified natural capital material issues to their long-term risk assessment process and, if material
- explicitly incorporate natural capital risk analysis into relevant governance structures.

Summary

Evolving definitions of materiality are expanding the boundaries of what might be deemed a material issue to an organisation across three key areas:

- the **scope** of issues included – broadening from only economic matters, to include wider social and environmental issues
- the **stakeholder groups** considered – expanding from a focus on economic stakeholders to include other internal and external individuals and groups
- the **time frame** over which issues are taken into account – extending from impacts that affect only the short term to those with longer-term effects and consequences.

Natural capital is likely to be increasingly regarded as a material business issue owing to its connection with the expanding boundaries of these three key areas.

Including natural capital issues in corporate materiality and risk assessments offers a range of benefits and value for companies in three key areas:

- better-informed decision making by an organisation, and its stakeholders
- an enhanced and more comprehensive risk-management process
- an increased ability to realise strategic opportunities.

Further Information

Gordon Hewitt, Sustainability Advisor, ACCA,
gordon.hewitt@accaglobal.com

Cecilia Repinski, Director, Natural Value Initiative of Fauna & Flora International, cecilia.repinski@gaiavalues.org

Dr Stephanie Hime, Lead Specialist – biodiversity and ecosystem services, Sustainability Services in KPMG UK,
stephanie.hime@kpmg.co.uk

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Glossary of terms

Biodiversity The variability among living organisms from all sources at a species, habitat and genetic level – a constituent of natural capital¹⁵

Ecosystem A dynamic complex of plant, animal, and micro-organism communities and their non-living environment interacting as a functional unit,¹⁶ e.g. ecosystems include deserts, coral reefs, wetlands or rainforests

Ecosystem services The benefits, closely dependent on biodiversity, that human beings obtain from ecosystems¹⁷

Environmental assets Naturally occurring entities that provides environmental ‘functions’ or services.¹⁸

Materiality assessment A process using stakeholder engagement to understand the specific issues that are most relevant to an organisation in order to inform decision making and reporting

Materiality matrix A tool, often used in materiality assessments, to identify and prioritise issues, risks and opportunities by plotting issues on a graph according to their importance to an organisation and to its stakeholders

Natural capital The stock of natural ecosystems that yields a flow of valuable ecosystem goods or services¹⁹

Natural resources Materials that occur in nature that can be used for economic consumption

Stakeholders Any individual, organisation, sector or community who has a ‘stake’ in the outcome of a given decision or process²⁰

Acronyms used

AA1000 AccountAbility’s framework for an organisation to identify, prioritise and respond to its sustainability challenges

FASB Financial Accounting Standards Board

FRC Financial Reporting Council

GRI Global Reporting Initiative

– **3.1** – Reporting guidelines version 3.1

– **G4** – Reporting guidelines 4

IAASB International Auditing and Assurance Standards Board

IASB International Accounting Standards Board

IFAC International Federation of Accountants

IIRC International Integrated Reporting Council

KPI Key Performance Indicator

NGO Non-Governmental Organisation

SEC US Securities and Exchange Commission

Notes

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