CAPITALS COALITION

Disclosing impacts on natural, social & human capital in financial statements

A discussion paper

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Acknowledgments

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Introduction

“I am convinced that we have to redefine capitalism. We must not only take into account financial capital, but also social capital, natural capital and human capital.”

Klaus Schwab, Chairman World Economic Forum, September 2020, ZEIT

Public calls to redefine capitalism are becoming more common and this paper is being released against exciting developments in non-financial reporting. The International Financial Reporting Standards (IFRS) Foundation has released proposals for a Sustainability Standards Board and the European Financial Reporting Advisory Group (EFRAG) has released its recommendations to the European Commission for the elaboration of possible EU sustainability reporting standards. Whilst these reports highlight the need to improve non-financial reporting, the possibility that the approach to financial reporting also needs to develop should not be forgotten and is the focus of this paper.

The evolving context for financial statements

The context in which businesses now operate has been transformed by the triple challenges of increasing climate change, loss of biodiversity, and rising inequality. The probability of these occurring and their intensity when they do occur has increased in recent years. This has led to businesses starting to use a capitals approach to identify, measure and value their impacts and dependencies on nature and people to include in their decision-making processes.

Investors are also now demanding more information on the risks associated with natural, social and human capital and the extent to which an entity is contributing to these. The fast-changing global context within which financial statements are prepared and audited also increases the chance that information that is now useful may not yet be included. There have been several responses to this challenge which can be grouped as:

- Additional non-financial reporting, covering a very wide variety of information and formats.
- Widening aspects of the scope of financial reporting.
- Addressing risks that material information is missing from financial statements.

Further detail of the work undertaken to date across these three themes is covered in the Appendix. However, many of these responses share the goal of improving the information made available on performance and stewardship for the users of financial reports (existing and potential investors, lenders, and other creditors).

Key terms used in this paper are set out in the Glossary.

Aim of this paper

Financial reporting is an umbrella term that includes several different reports, including the financial statements. This paper starts with the proposition that the most effective place for information on performance and stewardship to inform user decisions and shift resource allocation at the speed and scale needed is in the financial statements. That is, in the calculation of the assets, liabilities, income, expenditure, and, critically, the equity of a reporting entity. One type of information that informs an understanding of performance and stewardship is a business's impacts on the capitals and the management of those impacts.

This paper aims to explore the interface between financial and non-financial reporting in this context and to stimulate discussion on:

- The opportunities for disclosure of impacts on all capitals that are assets or liabilities within financial statements, based on existing accounting standards.
- Where the disclosure of those impacts could be considered within financial statements.
- Where there are not opportunities for disclosure, the specific areas where the application of accounting and auditing standards or the standards themselves could evolve.

This means that the scope of this report is limited to:

- Impacts on the capitals, although the importance of considering dependencies on the capitals should not be ignored.
- Disclosure of intangible assets only where these relate to impacts on the capitals.
- Assets and liabilities, although financial statements also provide information on income, expenditure, and equity.
- Additional assets and liabilities not currently disclosed and do not consider how information relating to impacts on the capitals could affect the disclosure of existing information, for example, to consider the impairment of assets.

Structure of this paper

This discussion paper follows the IFRS Conceptual Framework for Financial Reporting (hereafter the Conceptual Framework) and the IAASB standards in relation to:

- The concept of useful information – relating to Chapters 1 to 2 of the Conceptual Framework.
- Assets and liabilities – relating to Chapters 3 and 4 of the Conceptual Framework.
- The requirements for disclosure – relating to Chapters 5 and 6 of the Conceptual Framework.
- Assurance and audit – relating to IAASB.

The specific standards referenced are:

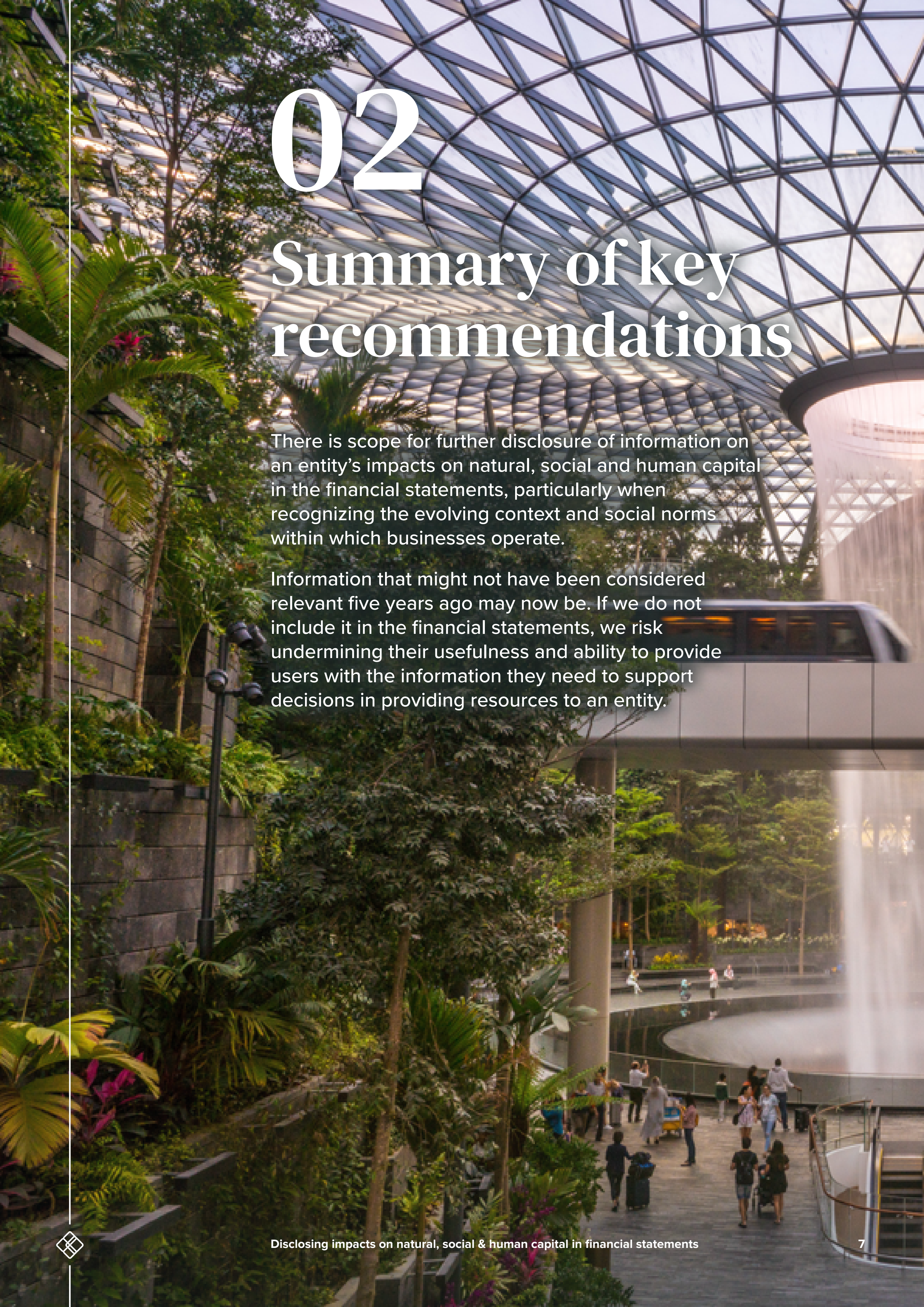
- The Conceptual Framework supported by relevant standards, specifically:
    - IAS 1 Presentation of Financial Statements;
    - IAS 36 Impairment of Assets;
    - IAS 37 Provisions, Contingent Liabilities and Contingent Assets; and
    - IFRS 13 Fair Value Measurement.
- The International Standards on Auditing and Assurance, specifically:
    - ISA 315 Identifying and Assessing the Risks of Material Misstatement;
    - ISA 320 Materiality in planning and Performing an Audit;
    - ISA 540 Auditing Accounting Estimates and Related Disclosures;
    - ISA 701 Communicating key audit matters;
    - ISA 720 The Auditors Responsibilities relating to other information; and
    - The IAASB project on Addressing Disclosures in the Audit of Financial Statements and IFRS Practice statement 2 Making Materiality Judgements.

Relevant paragraphs in the Conceptual Framework are referenced as (CF X.XX) where considered useful to the reader.

The format for each requirement within this section includes:

- A statement setting out how information about impacts on natural, social and human capital could meet the requirements to be included in financial statements.
- The key characteristics required by the Conceptual Framework and associated accounting standards to disclose such information.
- A discussion of how these characteristics can be applied to information about impacts on natural, social and human capital.
- The evidence to support **additional disclosure**, with reference to the relevant accounting or auditing standards as appropriate.
- The areas where **potential changes to accounting and auditing practice and standards** would be needed before further disclosure is possible.

We encourage readers to contribute to the discussion and to consider applying the conclusions in preparing both financial statements and sustainability or other reports relating to impacts.



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Summary of key recommendations

There is scope for further disclosure of information on an entity's impacts on natural, social and human capital in the financial statements, particularly when recognizing the evolving context and social norms within which businesses operate.

Information that might not have been considered relevant five years ago may now be. If we do not include it in the financial statements, we risk undermining their usefulness and ability to provide users with the information they need to support decisions in providing resources to an entity.

Opportunities for additional disclosure

Opportunities for additional disclosure under existing accounting standards appear predominantly in the notes to the accounts, particularly in relation to:

- Previously undisclosed economic phenomena arising from impacts on natural, social or human capital.
- A subset of users who require information relating to impacts as well as financial returns, where this is material in the context of the entity.
- Qualitative information that is otherwise relevant and important to users, but is assessed as not material in its effect on the financial statements.
- Public statements, commitments, or information provided by the entity that give rise to constructive liabilities, or assets.

Opportunities requiring further consideration

Opportunities for additional disclosure that require further consideration include:

- Providing additional guidance from IASB and IAASB on the disclosure of assets and liabilities that arise because of the entity's impact on natural, social and human capital.
- Providing additional guidance on what are considered 'reasonable' economic decisions (in relation to avoiding a liability), especially in the context of an entity's contributions to impacts that increase the risk of a breakdown in social systems.
- Recognizing valuation techniques as estimates of equivalent income or expenditure in developing accounting estimates.
- Considering whether the requirement for no practical ability to avoid meeting an obligation should consider:
    - Social norms and/or responsible business practice in deciding what is practical; and,
    - Increase the timescale over which economic costs and benefits of avoidance are assessed.
- Reviewing audit guidance to strengthen an auditor's assessment of the risk that new economic phenomena arising from impacts on natural, social and human capital have been missed, or not considered material. Reviewing associated processes and controls to address this risk.
- Making specific references in audit standards to impacts, and sources of information that might inform the risk of misstatement (e.g., issues raised by civil society organizations, press, or others in relation to the businesses' natural, social and human capital activities).

More significant changes to accounting standards

A more significant change to the scope of financial reporting and the financial statements, which would have far-reaching implications for current financial reporting, would be to include the consequences of the entity's operations on nature and people by recognizing that:

- The purpose of financial returns is to increase wellbeing **and** the wellbeing of users depends in part on how an entity's operations affect the wellbeing of others; or
- Decisions to provide resources depend on both expected returns and expected impacts on others.

This would result in a change to the Conceptual Framework, for example, para 1.3 could be changed to include the text shown in yellow:

'[Investor] decisions… depend on the returns that existing and potential investors, lenders, and other creditors expect, and on the entity's net impacts on others… Investors', lenders' and other creditors' expectations about returns and impacts depend on their assessment of the amount, timing, and uncertainty of… future net cash inflows to the entity; the impacts of the entity; and on their assessment of management's stewardship of the entity's economic resources and impacts.'

Figure 1 presents a series of tests to illustrate how information relating to impacts on natural, social and human capital is capable of being useful and therefore disclosed in financial statements, based on the Conceptual Framework guidance.

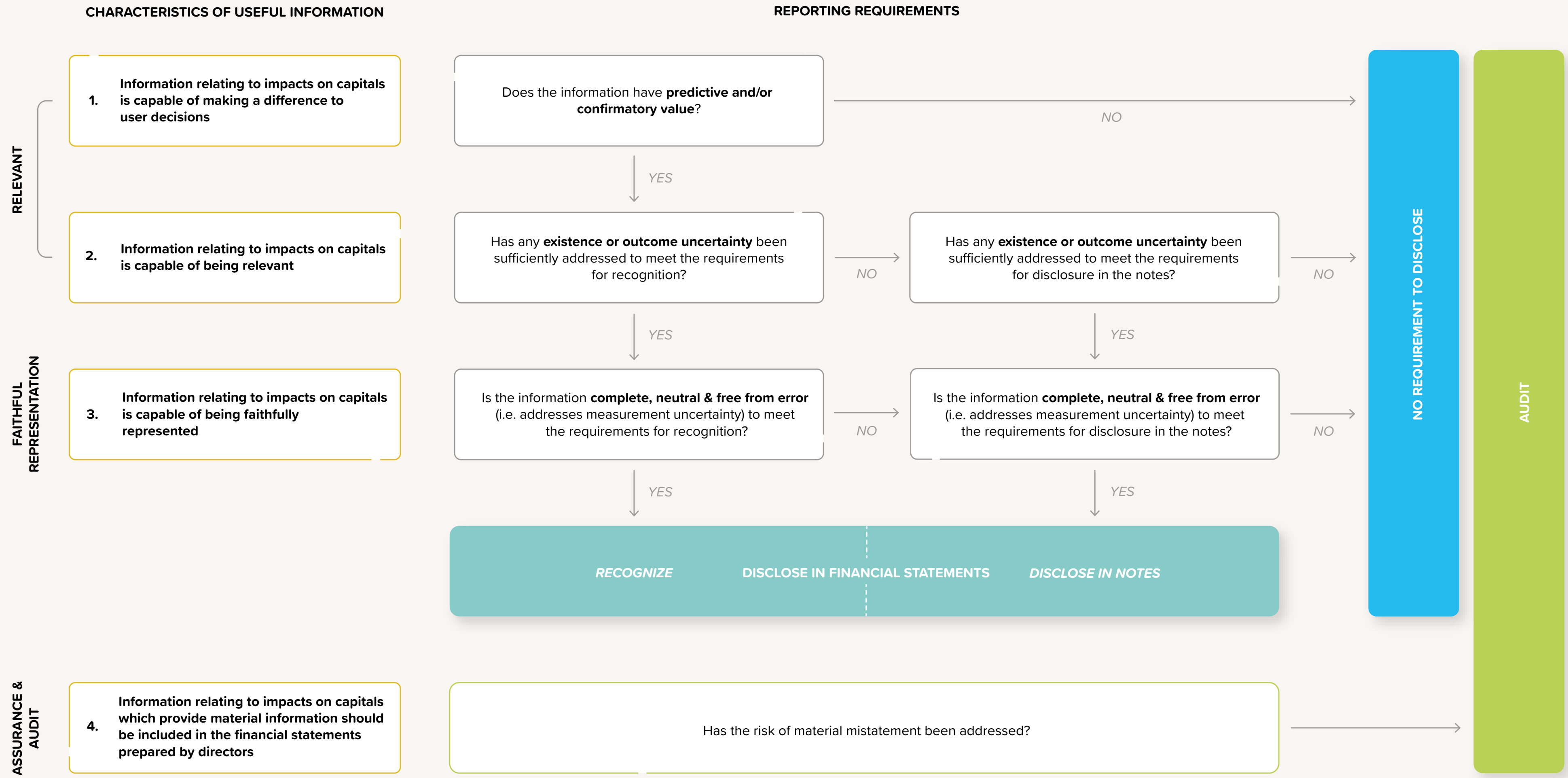


Figure 1: Decision tree for determining disclosure in financial statements.
This decision tree is based on the Conceptual Framework. It is not a standard but is designed to describe the objectives and concepts of financial statements. Therefore, the tests in this figure are not specific to accounting standards and should be interpreted as an illustration rather than specific guidance.
The term 'capitals' is used to refer to natural, social & human capital.

03

Objective & scope of financial statements

The objective of financial statements is to provide information to the primary users that is useful in making decisions to provide resources to the reporting entity. This includes information on the economic resources of the reporting entity, claims against the entity, and changes in those resources and claims that can be categorized as assets, liabilities, income, expenditure, and equity.

The concept of 'useful' information

Information relating to impacts on natural, social and human capital has the potential to be useful.

'The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity' (CF 1.2).

These decisions relate to:

- Buying, selling, or holding equity and debt instruments.
- Providing or settling loans and other forms of credit.
- Exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources (CF1.2).

The decisions depend on the returns that existing and potential investors, lenders, and other creditors expect, for example, dividends, principal and interest payments, or market price increases (CF 1.3).

To make these decisions, primary users need to assess the amount, timing, and uncertainty of future net cash inflows and management's stewardship of the entity's economic resources. This requires information on:

- The economic resources of the entity; claims against the entity; and changes in those resources and claims (the economic phenomena).
- How efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources (CF 1.4).

Qualitative characteristics of useful information

Deciding what information to include in the financial report requires the identification of all potentially useful economic phenomena.

'First, identify an economic phenomenon, information about which is capable of being useful to users of the reporting entity's financial information.' (CF2.21)

These are then tested against the requirements of the accounting standards, in the context of the Conceptual Framework. Information that meets these requirements is disclosed.

The Conceptual Framework states that information on these economic phenomena must be **useful**. The fundamental qualitative characteristics of useful information are that it must be:

- **Relevant** (capable of making a difference in the decisions made by users); and
- **Faithfully represented** (that is complete, neutral, and free from error) (CF 2.5).

Identifying & including economic phenomena

There are two key challenges that contribute to the risk that not all useful information on economic phenomena is included in financial reports. These arise from the challenges of:

- Identifying all potential economic phenomena, particularly new ones arising from changing economic conditions such as natural, social and human capital. This is considered, for example, in IFRS Practice Statement 2: Making Materiality Judgements which seeks to reduce this risk (IFRS PS 2 33); and
- Ensuring a robust and effective process for testing identified economic phenomena for relevance and faithful representation.

Impacts on natural, social and human capital have increased over recent years, and this increases the risk of sub-optimal decision-making if economic phenomena relating to those impacts are either not identified or are identified but not considered to be useful. The directors are responsible for ensuring that the financial statements include all useful information. The auditor is responsible for assessing the risk that useful information is missing. Consequently, the audit process should consider internal controls over-identified phenomena but also the adequacy of the process for identifying new phenomena.

Assets & liabilities

Information relating to impacts on natural, social and human capital is capable of meeting the definition of an asset or a liability.

Financial statements provide information about economic resources of the reporting entity, claims against the entity, and changes in those resources and claims, that meet the definitions of the elements of financial statements (CF 3.1). The key elements are assets, liabilities, equity, income, and expenses, and this paper focuses on the characteristics of impacts on natural, social and human capital that meet the definition of assets and liabilities set out in Chapter 4 of the Conceptual Framework.

The Conceptual Framework defines an asset as:

'A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.' (CF 4.2)

This means it can direct the use of the resource and obtain the rights to the economic benefits (CF 4.15). The initial perception would be that the nature of impacts on natural, social and human capital, even where they result in economic benefits for other people, does not meet this definition. There may also be no obligation for the people or organizations receiving that economic benefit to transfer any part of that benefit to the entity.

However, where those impacts affect the entity's reputation and its license to operate, and this has the potential to generate economic benefits there would be an asset.

The Conceptual Framework defines a liability as:

'A present obligation of the entity to transfer an economic resource as a result of past events.' (CF 4.2)

An obligation is an unavoidable duty or responsibility. The obligation must have the potential to transfer an economic resource, but it does not need to be certain or likely that the entity will need to make the transfer. It may be required only if an uncertain future event takes place (CF 4.37). Finally, it must relate to past events where the entity has already obtained economic benefits or taken action and therefore, will or may have to transfer an economic resource that it would not otherwise have had to transfer (CF 4.43).

Negative impacts on natural, social and human capital relate to consequences that are not covered within contracts but relate to a potential **constructive or contingent liability**.

Constructive liability

Obligations can be established by contract, legislation, or similar (including equity law or other legal requirements (IAS 37 10)). However, where impacts on natural, social and human capital relate to negative effects on people's wellbeing caused by the past actions of the entity, a constructive liability may exist. This is where an obligation can be constructed from an entity's customary practices, published policies, or specific statements, including those relating to sustainability issues or impacts, where the entity has no practical ability to avoid the obligation (i.e., no practical ability to act in a manner inconsistent with those practices, policies or statements) (CF 4.31). This includes a situation where avoiding the duty or responsibility would have higher economic consequences than the transfer, for example from loss of reputation.

Practical ability is informed by the entity's duty or responsibility, which could arise from social norms. The nature of duty or responsibility, and the timescale over which the economic consequences are assessed is not clear and therefore the judgment of what constitutes an entity's 'practical ability' in relation to discharging its responsibility depends on whether the decision to avoid liability was reasonable, informed by an assessment of stewardship or depended on a legal requirement.

The obligation may be constructed based on performance against targets, where those targets have generated the expectation that actions will be taken. It cannot be constructed based on targets themselves due to the requirement for the obligation to arise from a past event. Where the target date is in the future, for example, a target to be carbon net-zero, the date at which the liability is recognized remains uncertain. The liability calculation is based on the cost to meet the commitment or the negative impact on entity value from not meeting the commitment.

IAS 37 has similar requirements for a constructive obligation to the Conceptual Framework (where practice, policies, and statements have created a valid expectation that it will discharge those responsibilities), however, it does not specifically refer to the requirement for there to be no practical ability to avoid the obligation (IAS 37 10).

Impacts on natural, social and human capital may be impacts on society at large, or on a group of people. However, it is possible to construct an obligation to transfer resources to those people even when they have not been identified (CF 4.29) or the probability of making the transfer is low (CF 4.38).

Contingent liabilities

An alternative to constructing the obligation would be to consider whether there is a contingent liability that would be disclosed in the notes. Contingent liabilities are:

- Possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or

- Present obligations where either it is not probable that an outflow of economic resources will crystallize, or where a sufficiently reliable estimate of the amount of the obligation cannot be made.

The following section on '**Requirements for disclosure in financial statements**' addresses the requirements for information on assets or liabilities relating to impacts on natural, social and human capital to be useful for primary users, i.e., relevant and faithfully represented. This is set out in Figure 1 in the form of a decision tree.

04

Requirements for disclosure in financial statements

To meet the requirements for disclosure in financial statements, information relating to impacts on natural, social and human capital must be capable of making a difference to the decisions made by users, capable of being relevant, and meet the requirements for faithful representation.

1. Relevant

Information relating to impacts on natural, social & human capital is capable of making a difference to user decisions

Information relating to impacts and dependencies on natural, social and human capital is relevant i.e., capable of making a difference to the decisions made by users where it has:

- **Predictive value** (can be used to predict future outcomes such as an entity's future net cash inflows); and/or,
- **Confirmatory value** (provides feedback about previous evaluations)

that can influence the decision to provide resources to the entity (CF 2.7).

In the current global context and given that the purpose of financial reporting is to meet the needs of the maximum number of primary users (CF 1.8), it is important to test the current motivations of existing and **potential** investors (rather than the managers of their investments acting in their interests). It is also important to understand what information is capable of being useful to them when predicting (or confirming) assessments of future outcomes, and so deciding whether to provide economic resources to an entity.

The Conceptual Framework also requires relevant information to be material. This means that omitting or misstating such information could reasonably be expected to influence decisions that the primary users make (CF 2.11).

Even if this information is not **relevant** to the majority of users it could still be included if useful to a particular subset of users (CF 1.8). This does not though affect any over-arching decisions about materiality, which would still be made from the perspective of the reporting entity as a whole (CF 3.8).

Many factors that affect the assessment of future net cash inflows and financial statements are not intended to capture all these factors. Information relating to impacts on natural, social and human capital has implications for short- and long-term business options, and for prospects of future cash inflows.

Scope for additional disclosure

Where there are assets or liabilities arising from impacts on natural, social and human capital, there is scope for additional disclosure in the financial statements, subject to meeting the requirements to be relevant and faithfully represented.

Potential changes to accounting & auditing practices & standards

Users of financial statements may require information on economic phenomena relating to the consequences of the entity's operations on other people and organizations irrespective of the implications for financial returns when making relevant decisions. This would require additional clarification in the Conceptual Framework where currently the decision to provide economic resources depends on the expected returns. If it were recognized that the purpose of providing resources is to increase the wellbeing of the investor and that this is informed by both the expected returns and impacts to other people, then potentially useful information on economic phenomena (capable of making a difference to user decisions) would include the consequences of the entity's operations.

The change proposed above, which would have far-reaching implications for current financial reporting, would amend the Conceptual Framework (CF 1.3) to include the text shown in yellow:

'[Investor] decisions... depend on the returns that existing and potential investors, lenders, and other creditors expect, and on the entity's net impacts on others... Investors', lenders' and other creditors' expectations about returns and impacts depend on their assessment of the amount, timing, and uncertainty of... future net cash inflows to the entity; the impacts of the entity; and on their assessment of management's stewardship of the entity's economic resources and impacts.'

This perspective would have implications for what is relevant information relating to impacts and how it would be faithfully represented.

Information relating to impacts on natural, social and human capital that are assets or liabilities is capable of being relevant

Impacts relating to natural, social and human capital can be relevant to users of financial statements where:

- **existence** and **outcome uncertainty** have been sufficiently addressed.

The extent of any existence or outcome uncertainty must be considered when deciding whether information about such an asset or liability can be recognized or disclosed in the notes (CF 5.14 and CF 6.93).

Information about assets, liabilities, equity, income, and expenses is relevant to users of financial statements. However, recognition or disclosure in the notes may not provide relevant information because of existence and outcome uncertainty (CF 5.12 and CF 5.14).

- **Existence uncertainty** is uncertainty over whether an asset or a liability exists; and
- **Outcome uncertainty** arises from uncertainties about the probability of inflow or outflow of economic benefits (CF 5.12).

The low probability of an inflow or outflow of economic benefits does not mean an asset or liability does not exist, although again the best place for the information might be in the notes (CF 5.15 – 5.16). A low probability means more than remote, where remote means there is little chance of something occurring.

International recognition of the challenges of climate change and inequality (as reflected, for example, in the SDGs and The Global Risks Report 2020 (World Economic Forum)) means that the probability of an entity contributing to these impacts can no longer be considered remote.

Scope for additional disclosure

Subject to the requirements for faithful representation, the scope for additional disclosure relating to assets or liabilities depends on the assessment of existence and outcome uncertainty.

Currently, disclosures are not needed in relation to information that is not material (IFRS PS2 10). However, financial statements could include qualitative information on those risks that were identified as important to users but had not been assessed as affecting the financial statements. This has been proposed by the Australian Accounting Standards Board and Auditing and Assurance Standards Board in their 2018 report on Climate-related and other emerging risks disclosures.

There is increasing acknowledgment of the risks arising from negative impacts on natural, social and human capital by:

- **Entities**, leading to increases in practices, policies, or statements which include commitments relating to responsible business practices. This reduces the ability to avoid obligations arising because of these statements.

- **Governments**, leading to increased legislation requiring reporting and action by entities to address these impacts.

Consequently, the potential for additional disclosure of negative impacts on the capitals, most likely in the notes, is also increasing. Where the legal requirement is on a future date, the date on which the liability is recognized remains uncertain.

Directors of entities that have made statements relating to impacts on natural, social and human capital; produce reports on how these are being managed; or which align with various standards on both reporting and structure, might be more likely to include these obligations in financial statements.

Potential changes to accounting & auditing practices & standards

General acknowledgment of the risks arising from negative impacts is relatively recent and the inclusion of constructed obligations is not common. Further guidance by both IFRS and IAASB would increase the extent to which directors and auditors consider these potential obligations when preparing financial statements and when auditing them to assess the risk of material misstatement.

The IASB has a current project to consider targeted improvements to provisions. However, increasing disclosure might require changes to:

- The requirements for practical avoidance of obligations to consider the context of social norms and the entity's reputation.

- The timescale over which an assessment of the consequences of avoidance is made (and so the timing of recognizing a liability).

- The extent to which directors' fiduciary duties require these impacts to be managed.

More generally, clarifying or requiring disclosure of the assumptions where the assessment is that the obligation is remote or can be avoided would aid further disclosure. This could be aligned with the approach to disclosing assumptions where risks do not require impairment or other changes to the presentation of existing assets and liabilities.

Increasing the level of uncertainty that is considered acceptable for disclosure would result in further disclosures relating to impacts on natural, social and human capital. For example, when an entity's impacts on the capitals affect its reputation and license to operate, information about these impacts could still be considered useful. This is because tolerance for higher levels of both existence and outcome uncertainty could mean an asset is created and allow for disclosure, where otherwise these impacts would not meet this test.

Further disclosure would also result from changing the requirement for control which could arise from either:

- Changing the basis of user decisions to provide economic resources to include information on the entity's ability to generate and manage positive and negative impacts; or,

- Even if not relevant to all users, considering whether these impacts were nonetheless material in the context of the entity for a subset of users whose decisions are informed by these impacts.

2. Faithful representation

Information relating to impacts on natural, social and human capital that relates to assets and liabilities is relevant and is capable of being faithfully represented

Information relating to impacts on natural, social and human capital can meet the requirements for faithful representation, where it is:

- **Complete**;
- **Neutral**; and,
- **Free from error** (CF 2.13).

As these impacts often have little market activity, valuation methods and any associated measurement uncertainty are central concepts when determining if the information is sufficiently free from error.

There is no reason to assume that information relating to impacts on natural, social and human capital is, a priori, not complete or neutral, therefore this section focuses on the requirement for information to be free from error.

Free from error does not mean accurate in all respects (CF 2.18 and 6.59) and the Conceptual Framework addresses existence, outcome, and measurement uncertainty in relation to the requirement for information to be sufficiently free from error. Existence and outcome uncertainty was addressed under 'Relevant', and so the section below covers the requirements around **measurement uncertainty**.

Measurement uncertainty

In the Conceptual Framework for the financial statements, measurement means representing the economic phenomena in monetary units representing the potential inflow or outflow of economic resources.

'When a measure cannot be determined directly by observing prices in an active market and must instead be estimated, measurement uncertainty arises.' (CF 6.60)

Measurement uncertainty is different from outcome and existence uncertainty, although they may be contributing factors. Whilst a high level of measurement uncertainty associated with the chosen measurement approach does not necessarily affect whether the information is relevant, it may affect whether information provides a faithful representation.

For impacts on natural, social and human capital there is often little if any market activity, but this does not mean fair value measurement is not possible (IFRS 13 86 and 87). For example, where a liability has been constructed, it may or may not be held by other parties as an asset. In either case, the measurement could be based on the net present value of the amount expected to be paid in meeting the obligation.

Information relating to impacts on natural, social and human capital can face **measurement uncertainty**, but it can still be considered **free from error** if the level of confidence is clearly established, and limitations are clearly described. Even a high level of measurement uncertainty does not necessarily prevent the use of a measurement basis that provides useful information (CF 6.60).

As there is often little market activity for impacts on natural, social and human capital the choice of valuation method is a key component in deciding the level of uncertainty.

Valuation methods

The Natural, and Social & Human Capital Protocols set out several methods for valuation, many of which estimate the value of the impacts on those affected based on existing market prices. These approaches to valuation meet the IFRS 13 requirements for measurement where they are an estimate of the payment that would be made to cover the loss in wellbeing experienced, and are therefore the market participants', or the entity's expectations of future cash flows (IFRS 13 38). These can meet the requirements for being free from error, however, measurement uncertainty may mean the best place for the information would be in the notes.

The development of the Protocols as harmonized and internationally accepted frameworks for identifying, measuring, and valuing these impacts and dependencies, increases the convergence of technical valuation approaches and this reduces **measurement uncertainty**.

A related approach is to use the compensation payments that follow legal action for personal injury which include psychological damage amounts. This would be the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (IFRS 13 38).

Several methods could be used as part of a model to develop an accounting estimate which, together with the range and the assumptions, can then be disclosed (IFRS 13 63). In developing estimates, the amount paid is informed by what would be rationally paid, although rationality is not defined and the judgment of what is rational would be decided as part of the audit (IAS 37 37). As an example, the international recognition of the SDGs as a set of targets that need to be met to avoid catastrophic social and environmental impacts might suggest that it would be rational to act and make the associated payments to address these impacts.

Scope for additional disclosure

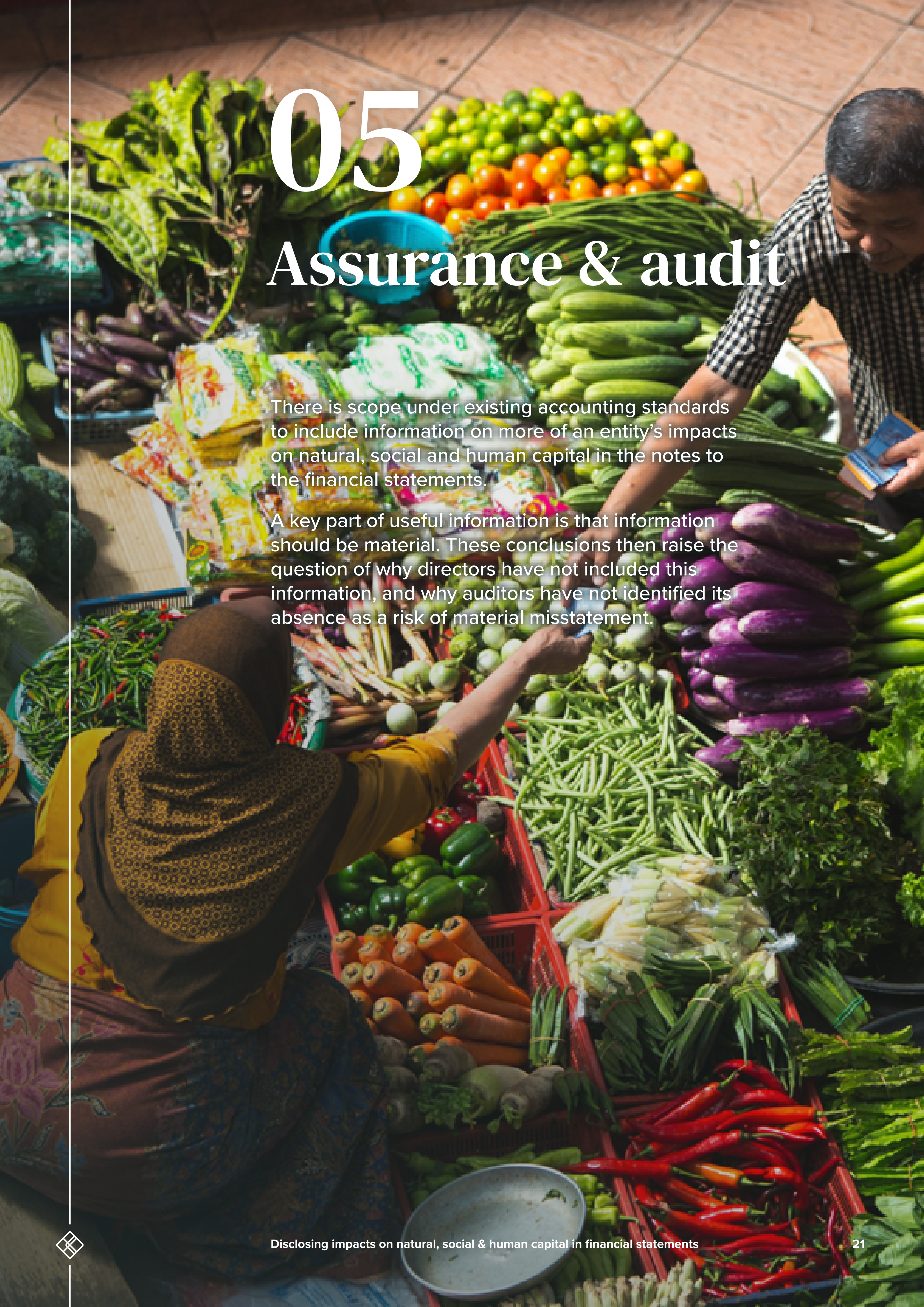
Where there are uncertainties of all three types, **recognition** of an asset or liability may not provide relevant information but **explanatory information** about the uncertainties associated with it may need to be provided in the notes (CF 5.14).

Given that liabilities represent outflows of economic resources and assets represent rights to economic benefits to the entity, there are likely to be higher levels of measurement uncertainty in relation to assets that are created because of impacts on the capitals.

The key issue for additional disclosure is the existence of the asset or liability rather than its subsequent outcome and measurement. Once economic phenomena exist (e.g., an obligation has been constructed), there is scope to use various valuation methods as part of estimating the net present value of expected payments to create an accounting estimate for measurement to be disclosed in the notes.

Potential changes to accounting & auditing practices & standards

IFRS 13 could recognize wellbeing valuation techniques as estimates of financial transfers, and these could be used in creating accounting estimates, even if limited to disclosure in the notes.



05

Assurance & audit

There is scope under existing accounting standards to include information on more of an entity's impacts on natural, social and human capital in the notes to the financial statements.

A key part of useful information is that information should be material. These conclusions then raise the question of why directors have not included this information, and why auditors have not identified its absence as a risk of material misstatement.

There is an increasing risk that material information relating to impacts and dependencies on natural, social and human capital is not being disclosed

Are there impacts on natural, social and human capital which provide material information but have not been included in the financial statements prepared by the directors?

The conclusion from the previous section is that there is scope to include more information relating to impacts on natural, social and human capital in the notes to the financial statements. This raises the question of why directors have not included this information, and why auditors have not identified its absence as a risk of material misstatement.

A potential reason, as raised in the introduction, is that this is because there is a lag between the rapid changes in the global context under which businesses operate, the resulting changes in information investors require, and the recognition that these may be material. Whilst it is the responsibility of the directors to prepare the financial statements, it is the function of audit to consider whether information about economic phenomena (relating to assets, liabilities, equity, income, and expenditure) that would influence the economic decisions of primary users is correctly included or is missing.

In this context, there is a risk that information on economic phenomena relating to impacts on natural, social and human capital:

- Is material, but has not been identified and therefore not disclosed; or
- Was identified as potentially material, but the judgment was that it did not meet the requirements for disclosure.

Determining materiality

'Information is material if omitting, misstating, or obscuring it could reasonably be expected to influence decisions that the primary users of general-purpose financial reports make on the basis of those reports, which provide financial information about a specific reporting entity.' (CF 2.11)

The auditor's determination of materiality is a matter of professional judgment which 'is affected by the auditor's perception of the financial information needs of users of the financial statements.' (ISA 320 4)

Information can be material at lower thresholds than is used for the financial statements as a whole if they could reasonably be expected to **influence the economic decisions of users**, including regulatory factors. Regulatory factors are not limited to legislation but include the legal and political environment and environmental requirements (ISA 315 A70).

The audit approach covers the financial statements as a whole and includes the disclosures in the notes as well as the balance sheet, profit and loss, and cash flow statement.

Assessing the risk of material misstatement

The purpose of the audit is to assess the risk of material misstatement and reduce this risk to an acceptable level, acting in the interests of the primary users. The level of acceptable audit risk is not stated in the standards and depends on the judgment of the auditor. If the information needs of primary users are changing, the level of **acceptable audit risk** could also change and could shift between, for example, **the risk of inaccurate presentation** and **risk of incompleteness**. Users might prioritize the completeness of information impacts and dependencies on natural, social and human capital over the accuracy of that information.

In performing the audit, ISA 540 addresses the audit of accounting estimates and other disclosures and would be the relevant standard for considering completeness of disclosures on impacts (and dependencies) on natural, social and human capital. This standard asks how the entity's information system relating to accounting estimates addresses the completeness of accounting estimates (and other disclosures) (ISA 540 2). It also raises the possibility that the auditor may identify issues that give rise to the need for accounting estimates or other disclosures that management did not identify (ISA 540 35).

In applying these standards to the risk of material misstatement, the auditor would need to ensure that the audit approach considered impacts and dependencies on natural, social and human capital as a potential source of issues that have not been identified by management.

Scope for additional disclosure

There is scope for reviewing audit processes against an impact lens. Even where no issues are identified that may require disclosure, there may be scope to raise issues relating to the disclosure of material impacts as part of Key Audit Matters, where there is a higher risk of material misstatement or audit judgment has involved significant management judgment.

Potential changes to accounting & auditing practices & standards

Audit processes should address the risk that new economic phenomena arising from impacts on natural, social and human capital have been missed, or not considered material and review processes and controls to address this risk. This could include, for example, reviewing the process undertaken to identify new, potentially useful economic phenomena without reference to historical practices and experience.

IAASB's recent update to ISA 720 on The Auditor's Responsibilities Relating to Other Information recognized the changing nature of reporting and the more diverse use of documents for external communication. In addition to this, it may be useful to have further guidance on the risks relating to impacts and dependencies on natural, social and human capital both in relation to the presentation of existing items but also in considering whether any assets or liabilities have not been disclosed, at least in the notes. In addition, the standards on identifying risk and planning for assurance could make specific reference to impacts and dependencies and on sources of information that might inform the risk of misstatement, for example, issues raised by civil society organizations, press, or others in relation to the businesses' natural, social and human capital activities.

The judgments around what are considered reasonable economic decisions may need clarification, especially in the context of not reporting on entity contributions to impacts that increase the risk of a breakdown in social systems.

06

Conclusions

"We need to adapt financial accounts to be a more holistic, accurate interpretation of the world, and remedy the current omission of nature and climate. Financial priorities need to be rethought with a different lens that considers a multi-capitals perspective, especially when analyzing performance and making decisions."

A4S, Building a Better Future, The Role of the Accounting Community, 2021

The concept of what is considered useful information to the users of financial reports is changing, and financial statements need to reflect this change

'...it takes time to understand, accept and implement new ways of analyzing transactions and other events. Nevertheless, establishing a goal towards which to strive is essential if financial reporting is to evolve so as to improve its usefulness.' (CF1.11)

Determining useful information requires judgment, initially by the directors in preparing the financial statements and then by the auditors in assessing the risk of material misstatement. In a rapidly changing legislative and physical environment in which business models operate the context in which this judgment is applied is changing. Information that might not have been disclosed five years ago may now be relevant.

There is scope for information relating to impacts on natural, social and human capital to meet the requirements for disclosure. If we do not include such information in the financial statements, we risk undermining their usefulness to provide users with the information they need to support decisions in providing resources to an entity.

Ongoing discussion

We invite you to consider your own financial disclosure and how you identify the information that is 'useful' to users without overreliance on historic information or previous reporting processes.

We would be particularly interested in examples where you have disclosed information on natural, social and human capital impacts and dependencies in the financial statements.

We look forward to continuing the discussion and offer the opportunity to discuss the proposals set out here with us and with others in the growing community of practice. To find out more, go to www.capitalscoalition.org or email info@captialscoalition.org.

Annex

Related work undertaken to date

The paper builds on the Coalition report on Increasing the Visibility of Nature in Financial Accounting, which set out four options to include the capitals in the financial accounts. However, there is a broader body of work focussing on the three themes of:

a. Additional non-financial reporting.

b. Widening the scope of financial reporting.

c. Addressing risks that material information is missing from financial statements.

a. Additional non-financial reporting

There is a growing body of work on the standardization of what non-financial information should be provided by businesses. This standardization is increasing both from the supply side of standard setters and from the demand side of businesses.

This includes, for example:

- The European Financial Reporting Advisory Group (EFRAG) Proposals for a relevant and dynamic EU sustainability standard setting.
- The International Financial Reporting Standards (IFRS) consultation paper on establishing a Sustainability Standards Board.
- The Statement of Intent to Work Together Towards Comprehensive Corporate Reporting from the CDP, Climate Disclosure Standards Board (CDSB), Global Reporting Initiative, International Integrated Reporting Council, and Sustainability Accounting Standards Board.
- Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation from the World Economic Forum.
- The EU Life Transparent project which is aiming to standardize Natural Capital Accounting by creating consistency in how businesses measure and value their impact and dependency on natural capital.
- CDSB's paper on Accounting for climate - Integrating climate-related matters into financial reporting.
- The Institute of Chartered Accountants in England and Wales' position paper on Non-financial reporting: ensuring a sustainable global recovery.
- ACCA's A Simple Guide to Natural Capital Management for Corporate Reporters.

There is also increasing recognition that restricting information to investor requirements as set out in the Conceptual Framework does not capture the consequences of business operations. Whilst those experiencing these consequences outnumber investors, they cannot express their demand for this information. This issue is recognized, for example, in the United Nations Development Program SDG Impact Standards and the International Auditing and Assurance Standards Board's (IAASB) guidance on Extended External Reporting Assurance.

b. Widening the scope of financial reporting

There are several initiatives that are setting out ways to expand the information that is included in financial reporting and so integrate non-financial information within the financial statements.

This paper builds on the Capitals Coalition's report on Improving Nature's Visibility in Financial Accounting, which set out four options to include the capitals in the financial statements ranging from further analysis of existing information through to changing the basis for the calculation of profit.

Other examples which combine arguments for expansion with approaches for valuing impacts on natural, social and human capital include the Impact Weighted Accounts Initiative, Value Balancing Alliance, and Social Value International which are all a part of the Capitals Coalition.

c. Addressing risks that material information is missing from financial statements

There has also been guidance around the risk that material information that should be in the notes to the financial statements is missing.

EFRAG

EFRAG's Project Task Force on preparatory work for the elaboration of possible EU non-financial reporting standards (PTF) published its proposals in February 2021. This includes the criteria to be followed by reporting entities, the use of double materiality, the levels of reporting and standard-setting, value chain, and forward-looking information, and priorities & roadmap for the future.

International Accounting Standards Board (IASB)

The IASB's work on the disclosure problem started in 2013, tackling concerns that there was not enough relevant information, too much irrelevant information, and ineffective communication in the disclosures of financial statements. This resulted in the report Disclosure Initiative - Principles of Disclosure in 2018 which concluded that 'improving the way disclosure requirements are developed and drafted in IFRS Standards is the most effective way it can help to address the disclosure problem. Consequently, the Board decided to prioritize its Targeted Standards-level Review of Disclosures project'. This resulted in internal IASB guidance for use in developing and drafting disclosure objectives and requirements, which were then tested, resulting in proposed amendments to disclosure sections of IAS19 Employee Benefits and IFRS13 Fair Value Measurement.

Most recently the IASB released a paper Accounting for climate change: new IASB Guidance which was supplemented in November 2020 by educational material on Effects of climate-related matters on financial statements. This considers how climate risk could affect, for example, asset impairment, changes in the useful life of assets, changes in the fair valuation of assets, and changes in provisions and contingent liabilities arising from fines and penalties.

International Auditing and Assurance Standards Board (IAASB)

IAASB released Addressing Disclosures in the Audit of Financial Statements – Revised ISA and Related Conforming Amendments in 2015. This made several changes to International Standards on Auditing (ISAs) addressing disclosures in the notes, for example:

- Recognizing these could include explanatory or descriptive information (ISA 200);
- The use of information that is not part of general and subsidiary ledgers (ISA 300);
- Assessing how those responsible for governance ensure that statements include adequate disclosures (ISA 315);
- Referencing completeness of disclosures in relation to assertions about classes of transactions and completeness (ISA 315); and,
- Identifying omissions of information in disclosures as a risk of material misstatement (ISA 315).

The Australian Accounting Standards Board and Auditing and Assurance Standards Board

The Standards Boards jointly produced the Climate-related and other emerging risks disclosures report in 2018. This report concluded that even where risks did not require asset impairments, investors would want information on the assumptions underpinning that assessment. This means that financial statements should include reporting on risk where investors could reasonably expect the risks to have a significant impact on the entity - even where those risks do not affect the financial statements themselves.

Institutional Investors Group on Climate Change (IIGCC)

IIGCC produced a report in November 2020 on Investor Expectations for Paris-aligned Accounts which argued for specific disclosure that the goals of the Paris Agreement have been considered in drawing up the accounts; adjustments to critical assumptions and estimates consistent with net-zero by 2050; sensitivity analysis; dividend resilience; and consistency of narrative reporting with accounting assumptions.

Glossary

Capital(s): A stock of resources that combine to yield a flow of benefits to people. In financial reporting 'capital' refers specifically to the economic resources that support the operations of an entity. This has been expanded to four main commonly used categories of 'capital' (natural, human, social, and produced capital).

Complete: A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations (Conceptual Framework for Financial Reporting 2.14).

Disclosures: Disclosures refer to the information necessary for a user of financial statements to understand the economic phenomenon depicted, including all necessary descriptions and explanations. (Adapted from Conceptual Framework 5.25 (c)).

Economic phenomena: The economic resources of the entity, claims against the entity, and changes in those resources and claims. (Conceptual Framework for Financial Reporting 2.2)

Faithful representation: To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral, and free from error. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximize those qualities to the extent possible (Conceptual Framework for Financial Reporting 2.13).

Free from error: Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects (Conceptual Framework for Financial Reporting 2.18).

General-purpose financial reports: General purpose financial reports (financial reports) provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions relating to providing resources to the entity (Adapted from Conceptual Framework for Financial Reporting). The European Commission defines financial reports as the financial statements and the management report.

General-purpose financial statements: General purpose financial statements (financial statements) are a specifically structured form of general-purpose financial reports that provide information about economic resources of the reporting entity, claims against the entity, and changes in those resources and claims, that meet the definitions of the elements of financial statements. The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, equity, income, and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources.

That information is provided (a) in the statement of financial position, by recognizing assets, liabilities, and equity; (b) in the statement(s) of financial performance, by recognizing income and expenses; and (c) in other statements and notes, by presenting and disclosing information about:

i. Recognized assets, liabilities, equity, income, and expenses (see paragraph 5.1), including information about their nature and the risks arising from those recognized assets and liabilities; and

ii. Assets and liabilities that have not been recognized (see paragraph 5.6), including information about their nature and about the risks arising from them; (Conceptual Framework 3.3) (Adapted from Conceptual Framework for Financial Reporting).

Materiality: Information is material if omitting, misstating, or obscuring it could reasonably be expected to influence decisions that the primary users of general-purpose financial reports make based on those reports which provide financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report (Conceptual Framework for Financial Reporting 2.11).

Measurement: Elements recognized in financial statements are quantified in monetary terms. This requires a choice of a measurement basis. A measurement basis is an identified feature - for example, historical cost, fair value, or fulfillment value - of an item being measured.

Neutral: A neutral depiction is without bias in the selection or presentation of financial information (Conceptual Framework for Financial Reporting 2.15).

Recognition: The process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements—an asset, a liability, equity, income, or expenses. Recognition involves depicting the item in one of those statements—either alone or in aggregation with other items—in words and by a monetary amount and including that amount in one or more totals in that statement (Conceptual Framework for Financial reporting 5.1).

Relevant: Relevant financial information is capable of making a difference to the decisions made by users (Conceptual Framework for Financial Reporting 2.6).

Useful: Useful information is information that existing and potential investors, lenders, and other creditors use in making decisions relating to providing resources to the entity. These decisions involve: (a) buying, selling or holding equity and debt instruments; (b) providing or settling loans and other forms of credit; or (c) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources. (Conceptual Framework 1.2)

To be useful, financial information must be relevant and capable of being faithfully represented (Adapted from Conceptual Framework for Financial Reporting 2.4).

CAPITALS
COALITION

The Capitals Coalition is a global collaboration transforming the way decisions are made by including the value provided by nature, people and society. Our ambition is that by 2030 the majority of business, finance and government will include all capitals in their decision-making, and that this will deliver a fairer, more just and more sustainable world.

www.capitalscoalition.org