

Financial Reporting of Natural Capital

Extract, PSA Discussion Group Report on the Public Meeting – November 12, 2021

The submission asked the Group to discuss public sector entities' financial reporting of natural capital. The submission was prepared by Group member Robert Siddall and other experts involved in reporting natural capital and sustainability:

- Joanna Eyquem, Managing Director, Climate-Resilient Infrastructure, Director of Quebec Programs, Intact Centre on Climate Adaptation, Faculty of Environment, University of Waterloo;
- Roy Brooke, Executive Director, Municipal Natural Assets Initiative and Principal, Brooke & Associates;
- Bailey Church, Partner and Leader of National Public Sector Accounting Advisory Services - KPMG;
- Michelle Molnar, Technical Director of the Municipal Natural Assets Initiative, CPA Canada and Environmental Economist and Policy Analyst, David Suzuki Foundation; and
- Ece Ozdemiroglu, Founding Director, Economics for the Environment Consultancy.

The Group was asked to discuss what the public and its elected representatives need to know about the natural capital of a public sector entity in order to hold it accountable for the management, use, maintenance, growth, depletion or disposition of the natural capital for which it is responsible. The Group was asked to discuss:

1. What aspects of this information about natural capital can be presented in financial statements?
2. What aspects of this information about natural capital is better presented in reports other than financial statements? What form should the reports take: part of an existing report (e.g., FSD&A1 or a Performance Report²) or a new report?
3. What other key factors may need to be considered when integrating natural capital into financial reports?

Issues

The submission provided Group members with background materials to consider, as the concept of accounting for natural capital is an emerging issue. The following was introduced as preamble to the discussion:

¹ FSD&A (Financial Statement Discussion and Analysis), general guidelines for which are set out in Statement of Recommend Practice (SORP) 1, *Financial Statement Discussion & Analysis*. SORPs are not part of GAAP. They provide general guidance on reporting outside of financial statements and may be useful when public sector entities choose to prepare such reports.

² SORP-2, *Public Performance Reporting*, sets out general guidelines for preparing performance reports.

- The Canadian context in relation to natural capital: specifically, the significant wealth of natural capital held across Canada in the public sector.
- A generally accepted idea in financial reporting that “what gets measured, gets managed”: This was noted in support of the need to inventory, value, and monitor natural capital so it is considered in decision-making and public sector entities can be held accountable for its use, sale, depletion, etc.
- Why now? It was noted that the public sector could help mitigate climate change by investing in natural capital, especially green infrastructure that provides ecosystem benefits in addition to its structural functionality.
- The road ahead: Significant work needs to be done to establish standards that include natural capital and consider its biodiversity and ecosystem benefits, not just its extraction value.

The Group first discussed what information about natural capital can be reported in financial statements. Overall, many Group members concluded that a measured approach and gradual integration of natural capital into financial reporting would be essential.

One Group member noted governments at different levels may share responsibility for ensuring the sustainability of natural capital. Some governments are currently working on accounting for natural capital. Governments may be seen to have an obligation to maintain the natural capital in their jurisdictions. However, the balance between economic development and environmental stewardship remains a challenge.

Most Group members noted the standard-setting process is lengthy. Specifically, they recognized it would be appropriate to begin working toward the reporting of natural capital on a timely basis. One of the submitters detailed various efforts undertaken in other jurisdictions such as:

- progress is being made in the United Kingdom to issue guidelines, best practices and standards; 3,4
- research and improved data and analytics in inventorying and measuring natural capital;
- improved asset-management systems and technology facilitating timely reporting of natural capital;
- additional efforts of various standard setters and policy makers integrating natural capital into financial reporting.

Many Group members questioned what type of information would be contemplated for reporting natural capital in financial statements. One Group member mentioned that certain aspects of the environment and its ecosystems provide an intrinsic value for which measurement may be difficult or not possible.

³ Natural Capital Account for Northern London Borough of Barnet:

<https://barnet.moderngov.co.uk/documents/s40941/Appendix%20%20Natural%20Capital%20Account%20for%20Barnet.pdf>

⁴ Guide for Natural Capital of Great Manchester: <https://www.greatermanchester-ca.gov.uk/what-we-do/environment/natural-environment/natural-capital/natural-capital-user-guide/>

One Group member explained that natural capital may have different meanings and values to different individuals and public sector entities. Three Group members explicitly acknowledged the importance of involving Indigenous communities in developing financial reporting requirements for natural capital. Natural capital is very important to Indigenous peoples given their traditional stewardship of the lands and waters. The lands and waters have cultural significance for Indigenous communities and impact their financial and physical sustainability. A Group member noted the following from an Indigenous perspective:

- What can be classified as an asset by a public sector entity may be impacted by Indigenous land claims, treaties, etc. Such legal questions could affect whether natural capital is considered controlled by a government or other public sector entity currently considered to have “inherited” the lands of which the natural capital is a part. Contingent liabilities related to such claims may arise for that government or other public sector entity in relation to such lands.
- Ownership and control of certain types of assets, such as Crown land, would need to be assessed to consider such legal contingencies. Control over natural capital on reserve lands is also an issue to be considered.
- The impact of climate change on their ancestral way of life is significant for Indigenous communities.
- The economic value of natural capital goes far beyond its extraction value. Natural capital has qualitative values: biodiversity, a healthy environment, mitigation of environmental events, foundation of Indigenous cultures, etc. Several Group members shared this view.
- One Group member suggested broader engagement with Indigenous peoples in developing standards relating to natural capital. Another Group member suggested PSAB use Indigenous knowledge in establishing standards for natural capital and that Indigenous communities should be partners in establishing any requirements. Given the importance of natural capital to their world view, Indigenous perspectives would be critical in understanding the value of natural capital beyond its extraction value. A holistic approach makes sense for natural capital, including consideration of subsoil resources, the air above lands, the interconnectedness of types of natural capital, and the nature of inter-related ecosystem and biodiversity benefits natural capital provides.

A Group member noted it would be important to determine the following prior to having wider discussions about financial reporting of natural capital:

- What are the objectives of holding the natural capital? These objectives could be disclosed in financial statements. They would provide important context for decision-making in relation to natural capital held and may have implications for reporting natural capital in financial statements. If the purpose for holding natural capital is not achieved, would there be any obligations that are liabilities for the relevant public sector entity? For example, would liabilities be created if there are violations of contracts or government commitments? Or would there be social impacts created that give rise to obligations if natural capital held is not managed to achieve objectives?

Several Group members expressed concerns with integration of the reporting required, such as:

- Consistent presentation and measurement within public sector entities' financial statements would be important for user understandability.
- Measuring, verifying, and monitoring natural capital will be challenging, and audit issues may also arise.
- Consider key commitments of Canada and note contributions required to achieve them from different levels of government; will meeting or not meeting them have financial statement implications?

One Group member questioned whether natural capital should be reported in financial statements, as their focus is fiscal rather than environmental. A separate report was suggested as an alternative, given that most natural capital information would be qualitative. The Group member continued, noting that governments operate with a different mindset:

- Governments operate on a cash and revenue/spending basis and focus on achieving a balanced budget.
- Public sector financial statements largely reflect items at historical cost. A market-based approach that takes into account costs and benefits would likely better reflect the value of natural capital, especially natural capital not acquired through an exchange transaction and for which a transaction price is unavailable.

Several Group members expressed concern that current financial statements cannot adequately report natural capital because quantitative value information would be insufficient, especially if focused on extraction value alone or if there is no initial investment cost. The value of natural capital may also vary depending on its location. Measurement attributes and approaches the International Public Sector Accounting Standards Board (IPSASB) is considering for heritage assets may provide a way to look at natural capital. Qualitative information explaining what any value reported represents would be important given the distinctiveness of natural capital.

The submitters mentioned that PSAB and chartered professional accountants (CPAs) in the public sector are best positioned to facilitate financial reporting of natural capital. They noted accountants speak the same language as chief financial officers (CFOs) and are trusted to make sure information reported is credible and unbiased.

The submitters shared their expertise and knowledge with the Group in relation to inventorying and valuing natural capital. They suggested disclosures should make clear what is included in reported values and what is not. They noted visibility of natural capital is crucial for managing it and considering it in decision-making and replacing a zero value with any value, even an imperfectly calculated amount, provides improved transparency. The submitters provided examples of current international initiatives to show that inventorying and valuing natural capital for financial reporting purposes does not present insurmountable issues. These examples can form a starting point for public sector entities. Work has already done that can be leveraged, including the United Nations' [Natural Capital Accounting and Valuation of Ecosystems Services](#) project.

Group members shared the following:

- Measuring the social return on investment in ecosystems is difficult.
- Reporting of any value, even if nominal, is better than zero as it provides a starting point and some visibility. Invisible resources (e.g., CO2 levels and ecosystems) can be sold or depleted without accountability. Reporting of natural capital may also encourage decision-makers to invest in “nature-based solutions,” including green infrastructure with its inherent climate mitigation and ecosystem benefits, rather than manufactured, single-function “grey” infrastructure (e.g., dams and reservoirs).
- In completing an inventory of natural capital, identifying monetary values may need to be a second step. First, public sector entities would develop a detailed inventory. Second, they would disclose the nature and extent of major types of natural capital in financial statements or other reports. Third, they would be reporting on the condition of the natural capital. This reporting, similar to reporting on infrastructure deficits, is likely most appropriate outside of financial statements.⁵
- Concerns were expressed about completeness of information on natural capital. A question was raised as to whether an incremental approach to disclosures by type of natural capital is possible.
- A big unknown is what initial investment may be required to complete an inventory of natural capital. Further, the costs may be incurred in the short term but the benefits for decision-making, accountability and sustainability would be realized over the long term. Benefits of climate-change mitigation related to management of natural capital may be realized in the shorter term.
- The focus needs to be on progress as opposed to perfection.
- Asset-management systems are beginning to measure and monitor aspects of natural capital. Initially, perhaps asset-management reports rather than financial statements might present natural capital, though requiring this is beyond PSAB’s authority to mandate. Financial reporting standards could then build on this asset-management work.

One Group member commented it would prove next to impossible to rationalize the meaning of dollar values for natural capital. Another Group member argued the overall objective should be to try as best as is possible to make the invisible become visible. Accountants may be initially uncomfortable with measuring new items in new ways, and reliance on specialists, as is done for other financial statement items, may be required. It was suggested that since international sustainability standards will be initially focused on the private sector, public sector sustainability reporting is an area where Canada could lead. Another Group member noted there remains the challenge of attempting to quantify items that do not have a direct economic use, or benefits that can easily be translated to a financial statement value that is auditable.

A Group member responded that the possibility of reporting natural capital in financial statements should not be dismissed as impossible given efforts underway in Canada and elsewhere to inventory and measure

⁵ As an example, see SORP-3, *Assessment of Tangible Capital Assets*.

some types of natural capital. A decision-tree approach could be used to filter down to types of natural capital that

- meet the asset definition and can be measured and recognized in financial statements;
- qualify only for disclosure; and
- need to be reported outside of financial statements while work is undertaken to develop information that would make them capable of financial statement disclosure or recognition.

The Group member added that such an approach could normalize and socialize non-financial reporting of natural capital, including disclosure of cost-avoidance and other benefits of managing natural capital. Another Group member commented that MEASUREMENT UNCERTAINTY, [Section PS 2130](#), may provide useful guidance for developing natural capital disclosures.

Many Group members contemplated approaches to measuring natural capital. While views and approaches differed, the following were raised:

- Just because natural capital items are unique, this does not mean their value cannot be reasonably estimated. The example of heritage assets was again referenced.
- Natural capital comprises many potential assets. Each category is distinct and may need different measurement techniques to estimate value.
- Completeness will never be entirely achieved given the evolving nature and ongoing depletion of natural capital, but this reality should not deter entities from making assumptions to establish reasonable estimates of the value of natural capital.
- Both financial costs to maintain natural capital and financial benefits derived from what an entity would forego by protecting them can be shown in monetary terms.
- Transparency is key. It is important to show all accountability information including the data and the assumptions made in compiling an inventory of the nature and extent of types of natural capital and in assigning value to them. Details should clarify what is included and excluded for valuation purposes, as well as descriptions of what was not measured.
- Performance reports may prove helpful in measuring achievement against climate-related commitments.

Many Group members did not agree on whether natural capital should be reported in financial statements. However, most agreed that some form of reporting of natural capital is needed. They noted the following:

- The CPA's role is to report relevant information to decision-makers.
- PSAB should use the work from the IPSASB's Natural Resources project to the extent possible and appropriate for Canada, as long as the focus is on more than extraction value. PSAB monitors IPSASB's work and contemplates the impacts and adoption on a project-by-project basis. It will be

important to continue to monitor IPSASB's work on natural capital in order to leverage and monitor how this may be applied to Canada.

- PSAB should emphasize what natural capital is currently allowed to be recognized under existing standards if it meets the asset definition and the general recognition criteria.
- Nature is complex. Its various aspects and ecosystems are interdependent, including humans, whose existence ultimately depends on nature. Separate reporting may be required to provide stakeholders with sufficient relevant information about this critical type of capital.
- Financial statements are important tools to foster stakeholder engagement. With climate-related topics being so critical, presenting some information about natural capital, including investments in green infrastructure, in public sector financial statements will assume greater importance for citizens.

Most Group members agreed CPAs have a vital role to play in having natural capital included in financial reporting for the following reasons:

- The International Sustainability Standards Board announced it will have an office in Montreal. This places Canada in the spotlight and gives the public sector and PSAB an opportunity to collaborate.
- If CPAs do not get involved, someone else will. Other professionals, such as environmentalists, economists, and engineers, may take the lead on this subject as climate-related reporting is moving forward with or without CPAs.
- CPAs converse with CFOs and stakeholders. CPAs can lead discussions with decision-makers on the importance and significance of accounting for natural capital.
- CPAs are deeply involved in standard setting and can assist in establishing guidance and standards.

Most Group members agreed some form of reporting of natural capital would be important for PSAB to consider, some members indicating it as a key priority for the Board. And many Group members agreed CPAs have the skills to make a difference in the reporting and management of natural capital. However, Group members differed in their views on the format, presentation, measurement and other considerations relating to reporting natural capital.

In conclusion, the Chair appreciated the comprehensive discussion, acknowledged its importance as a basis for PSAB's future work, and summarized some takeaways from the discussion:

- Group members agreed that inventorying natural capital would be the right first step.
- Some types of natural capital are more likely to meet the asset definition than others. Crown lands are an example of a more complex issue.
- Liabilities related to natural capital and government commitments on sustainability are possible.

- Under current generally accepted accounting principles (GAAP), incorporating natural capital in financial statements may be difficult because existing measurement attributes may not adequately capture some benefits associated with natural capital.
- PSAB could consider removing the recognition prohibition relating to inherited natural resources to allow experimentation with applying existing principles to all types of natural capital. Reference to current examples where reporting or disclosures of natural capital has been done might help in this regard. The Board could consider allowing an incremental approach to disclosures to foster such experimentation.
- Disclosure is a good first step but may provide less accountability than financial statement recognition would for the use, disposition or depletion of natural capital. The primary financial statements are perceived to carry more weight than note disclosures.
- PSAB should consider the perspectives of Indigenous peoples in developing recommendations for reporting natural capital. Perhaps for this particular issue a partnership approach would be more inclusive than the traditional consultation approach of exposing proposals for comment and encouraging Indigenous governments to input.
- Consider filters for assessing what information can be recognized or disclosed in financial statements and what might be better suited to reporting outside financial statements.
- Reliance on specialists would likely be required both for preparing reports that include natural capital and for auditing any information reported or disclosed in financial reports.
- There is a value to reporting quantified information in driving scrutiny and action; the invisible becomes more visible and is considered in decision-making.
- PSAB should leverage the work from IPSASB's Natural Resource project to the extent it meets the needs of Canadian stakeholders.
- A majority of Group members agreed the Board should consider including this topic in its next project-priority survey to determine its priority with stakeholders.

The submitters closed by asking PSAB and CPAs in the public sector to be at the table to facilitate financial reporting of natural capital. They noted accountants speak the same language as CFOs and are trusted to make sure information reported is credible and unbiased.