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RECOGNITION OF NATURAL CAPITAL IN FINANCIAL REPORTING IN THE CONTEXT OF THE SOCIO-ECONOMIC PARADIGM: PRACTICE OF THE REPUBLIC OF MOLDOVA AND INTERNATIONAL EXPERIENCE

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Abstract

In the context of ensuring sustainable development, the activity of a business unit has come to be seen as a three-component system designed to provide reliable information about the contribution of business to the social and environmental segments of the economy. This trend led to the transition to the socio-economic paradigm of financial reporting, which predetermines its revolutionary transformations, one of which is finding ways to recognize natural capital (NC) and disclose information about its impact on the value of the business as a whole. This article puts forward and proves the hypotheses, which leads to the following conclusion: the recognition of NC as an element of financial reporting is an imperative of the socio-economic reporting paradigm. This study was conducted on the basis of general scientific and special methods: systematic approach, collection and comparison, analysis, synthesis, modeling, study of special literature. The justification of the hypotheses is carried out according to the following scheme: the current state of natural capital of the Republic of Moldova is assessed; the national accounting and financial reporting system is characterized in the context of the requirements of the socio-economic paradigm; methodological aspects of the recognition of natural capital as an element of financial reporting are analyzed; an algorithm and arguments of the NC recognition model based on the provisions of IFRS are proposed.

Key words: *socio-economic paradigm, natural capital, methodology of IFRS, recognition algorithm, accounting model*

INTRODUCTION

The transition to a more advanced technological mode predetermines changes in economic relations and productive forces, implemented already in the new paradigm of society development.

Because of the focus on a homocentric vision of economic development through ensuring the quality of life of people, their rights and opportunities, while creating the necessary conditions to maintain a healthy environment, the paradigm of the XXI century is interpreted as socio-economic. The socio-economic paradigm or the Concept of Sustainable development provides for a balance of economic, environmental and social aspects of activity not only at the macro level, but also at the micro level [1]. In this context, business began to be interpreted as a three-component system, each of the components of which is characterized by its own ”driver” of business value growth - financial capital, natural capital and social capital.

There is no doubt that demonstrating the contribution of each form of capital to the sustainability of the business model requires adequate disclosure in business reporting. The *first stage* of this requirement was the preparation of GRI-reporting (Global Reporting Initiative), which focuses on material issues for business and other stakeholders. Thus, within the environmental aspect, such issues include: compliance with environmental legislation, environmental performance of products, energy efficiency, energy conservation and innovation, protection of land resources and vegetation. This information is mainly quantitative in nature, does not create a complete accounting of the business activities of a business unit, and does not reflect all the factors contributing to the growth of wealth and wellbeing [3], [5]. Certainly, on the one side, indicators of the environmental aspect of business activity should provide a quantitative description of its contribution to the achievement of sustainable development goals. On the other side, since the environmental behavior of business has an impact on natural capital, it is also necessary to value the contribution to the maintenance of natural capital [19].

The GRI-reporting framework uses a cost-based methodology to determine the environmental indicators for which cost estimation is possible. In doing so:

1) no consideration of the market value of resources;

2) the role of natural capital as a factor of production is ignored, although it has been proven that short-term economic growth results in a loss of natural capital;

3) non-market negative and/or positive externalities that affect the value of natural capital are not taken into attention [11].

And in this context, the key problem of natural capital disclosure is the development of an effective tool for measuring the contribution to the environmental sustainability of business. Its use will make it possible to draw conclusions about the sustainability of business models and trends in total business capital [19].

The Rio+20 Summit Declaration on Natural Capital (2012) recognized the interconnectedness of natural and financial capital and the need for accounting and financial reporting reform. The adoption of the System of Environmental-Economic Accounting – Central Framework (*second stage*) is part of this reform. System is a multi-purpose concept of business impact on the environment, which provides for the use of the principle of double entry and the opening of functional accounts for environmental activities.

This recognized the need to standardize information on new forms of capital that is presented on a consistent basis: helps to assess the past and look into the future [5]; influences management decision-making by stakeholders at both the state and corporate levels [8].

The idea of presenting information about new forms of capital was implemented in the concept of integrated reporting (*third stage*). The key assumption of this concept is the interpretation of capital as value, which includes two elements: 1) the value that ensures the return on investment to the depositors of financial capital; 2) the value from the participation of other stakeholders and society as a whole [9]. Moreover, this is the value of human, social, natural capital and other forms of capital. In this regard, the following theses are true:

T1 – natural capital as part of the second element of capital is monetarily measurable;

T2 – the value of natural capital and its impact on the value of business capital, to be disclosed in the financial statements.

Under this concept, natural capital refers to the stock that is the source of a sustainable flow of environmental (natural) services and real natural resources.

However, despite the obvious need to recognize natural capital and consider the risks, uncertainties, and opportunities associated with the use of the benefits it contains, not all business units reflect them in their financial statements [4].

Moreover, there is still no information about natural capital as a contribution to the total capital of the business in the financial statements. In this regard, a number of questions arise:

-What is the current situation of natural capital recognition in the Republic of Moldova?

-Is there a unified conceptual space for the presentation of information on natural capital in the accounting and financial reporting system of the Republic of Moldova?

-Does modern accounting methodology have the tools to recognize natural capital as an element of financial reporting of a business unit?

The answer to the questions posed will be the argumentation of the authors' hypotheses as presented in Fig. 1.

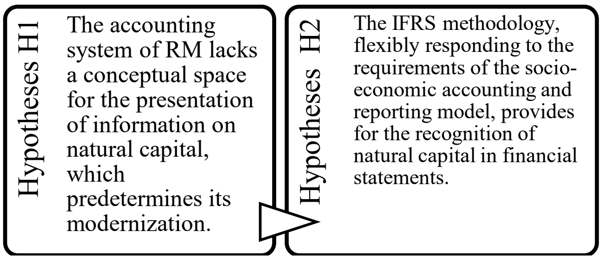

Fig. 1. Authors' hypotheses.
Source: Own concept.

Justification of the hypotheses is aimed at achieving the goal of the study: the recognition of natural capital as an element of financial reporting is an imperative of the socio-economic reporting paradigm. In the context of justification of the hypotheses, the following research algorithm was developed:

-assessment of the current state of recognition of natural capital of the Republic of Moldova (hereinafter, RM);

-characterization of the accounting and financial reporting system of the RM in the context of transition to the socio-economic paradigm of financial reporting;

-analysis of methodological aspects of recognition of natural capital as an element of financial reporting;

-improved model of natural capital recognition based on the provisions of International Financial Reporting Standards (hereinafter, IFRS or IAS) is proposed.

MATERIALS AND METHODS

This research is conducted on the basis of general scientific and special methods: system approach, collection and comparison, analysis, synthesis, modeling, study of special literature. The systematic approach of this research consists in a rational combination of certain scientific directed to the construction of research methodology: formulation of the problem, proposing a hypothesis and its justification.

The authors studied the works of famous scientists, published in scientific journals and as monographs in order to achieve the stated goal of the research. When forming the evidence base of the hypothesis, official materials were also used: legislative and normative acts, data published by the Bureau of Statistics of the RM. Depending on the tasks set, some of which are of empirical nature, others of theoretical nature, appropriate methods were applied. Such task of the research as presentation of information about the current state of natural capital in RM was solved by the authors with the help of methods of observation and comparison (Tables 1, 2, 3).

In the study of this problem, the authors were guided by the following methods:

abstraction to identify from the position of accounting methodology the properties of natural capital, which allow us to qualify it as a form of capital;

axiomatic - to formulate theses T1 and T2;

induction, the application of which made it possible to put forward hypotheses H1 and H2 to be argued;

analysis, which highlighted the stages of the natural capital identification algorithm;

synthesis, which made it possible to formulate conclusions and argue the hypotheses put forward and substantiate the methodology of natural capital accounting;

finally, *modeling*, on the basis of which the algorithm of identification of natural capital and functional accounts for the presentation of information on its state in financial statements were proposed.

RESULTS AND DISCUSSIONS

Conceptual analysis of the current state of natural capital in the Republic of Moldova and its recognition as part of business capital

In order to substantiate the hypothesis H1, let us disclose the current state of the most demanded types of natural resources in Moldova. For this purpose, we will use the official information, prepared by the National Bureau of Statistics (Tables 1, 2). The tables present generalized data on separate ecosystems of the RM.

The analysis of the information presented in Tables 1 and 2 shows the fact that at present in RM:

(1)There is a quantitative assessment of the criteria characterizing the state of natural resources (Table 1) and the factors determining the quality of natural resources (Table 2).

Table 1. Quantitative assessment of some ecosystems of the Republic of Moldova

n/n	Ecosystems	2018	2019	2020
1	**Land fund**, thousand hectares	3,384.7	3,384.7	3, 384.7
2	**Extractable minerals, including:** ▪ oil, (thousand tons) ▪ raw materials for cement (thousand tonnes). ▪ molding and other materials (thousand tonnes); ▪ rocks (million m³).	5.1 1,016.7 481.3 4,910.4	5.0 1,084.4 382.4 5,460.4	5.0 988.9 410.7 5,579.9
3	**Used water resources** (million m³) including: ▪ for production and agricultural needs ▪ for domestic needs.	777 666 111	777 667 110	778 666 112
4	**Fuel and energy resources consumed** (thousand tons), including: ▪ industry; ▪ transport; ▪ residential sector.	2,862 251 758 1,385	2,739 234 769 1,274	2,670 226 681 1,296
5	**Forest fund**, total (thousand hectares), including forest covered	422.8 379.5	423.9 380.7	425.4 381.8

Source: Own development based on data from the national bureau of statistics [15].

Table 2. Quantitative assessment of polluting emissions into ecosystems of the Republic of Moldova

n/n	Types of dirt	2018	2019	2020
1	Emissions of pollutants into the atmosphere (thousand tons) from: ▪ industrial production ▪ various types of transport, including motor vehicles	143.6 227.9 198.1	124.3 189.5 163.8	113.8 155.6 148.7
2	Emissions of pollutants into natural water bodies, including from energy production facilities (thousand tons)	139.1 125.3	186.7 166.3	181.4 168.9
3	Discharge of polluted water into the water space (million m³)	9	8	8
4	Industrial waste (thousand tons), including: toxic	1,597.3 4.26	1,222.0 4.14	1,191.0 2.10

Source: Own development based on data from the national bureau of statistics [15].

(2)There is a degradation of ecosystems, due to the constant growth of the level of their pollution with the preserved amount of relevant natural resources and environmental services (Fig. 2). It should be noted that the author deliberately focuses on the pollution of natural water resources. This is due to the fact that atmospheric pollution by production and transport, and the volume of waste from these segments of the RM economy decreased in the context of minimization of transport services provided and reduction of production capacity during the pandemic COVID 19 2020 and 2021.

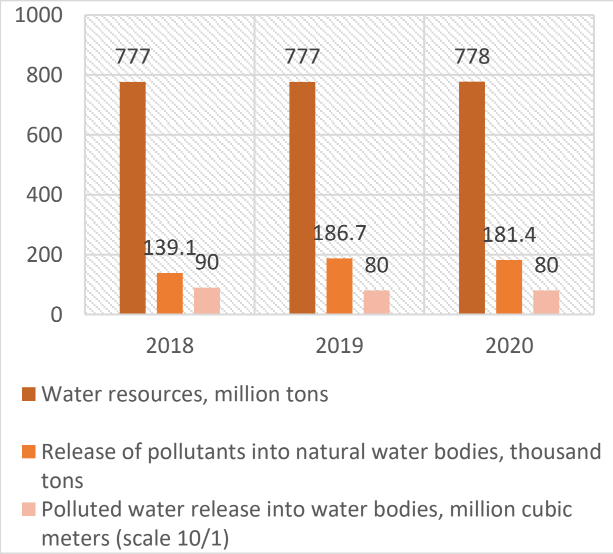

Fig. 2. Diagram of changes in the volume of natural water resources and discharges of their pollution in the period 2018-2020.
Source: Own design.

(3)The Business Unit incurs environmental costs due to production activities, which practically do not change over time (Table 3), and, therefore, the cost of the products/provided services does not change.

Table 3. Costs of economic agents of the Republic of Moldova for the environment and its restoration (thousand Mld.lei)

n/n	Types of expenses	2018	2019	2020
1	penalties for violating environmental laws	5,315.2	6,975.8	6,530.4
2	penalties for non-compliance with environmental legislation	7,809.1	18,428.4	22,000.2
3	current costs of economic entities due to interaction with the environ-ment, including: included in the cost of products/ servi-ces,recognized as expenses of the period	269,238.3 227,752.2 41,486.1	258,478.7 217,243.3 41,235.4	264,982.5 182,530.3 66,258.6

Source: Own development based on data from the National Bureau of Statistics [15].

(4)The size of ecosystems as a whole has not changed quantitatively (Table 1). However, businesses continue to carry out their

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activities and use ecosystem services. At the same time, as noted above, the level of environmental costs of business is quite stable (Fig. 2), the value of consumed ecosystem goods due to their limitation is steadily increasing over time, and, consequently, ecosystems are damaged;

(5) **Simultaneously with the above mentioned, there is a significant increase in the external costs of business** as a taxpayer due to penalties for violations of environmental legislation and environmental protection (Fig. 3).

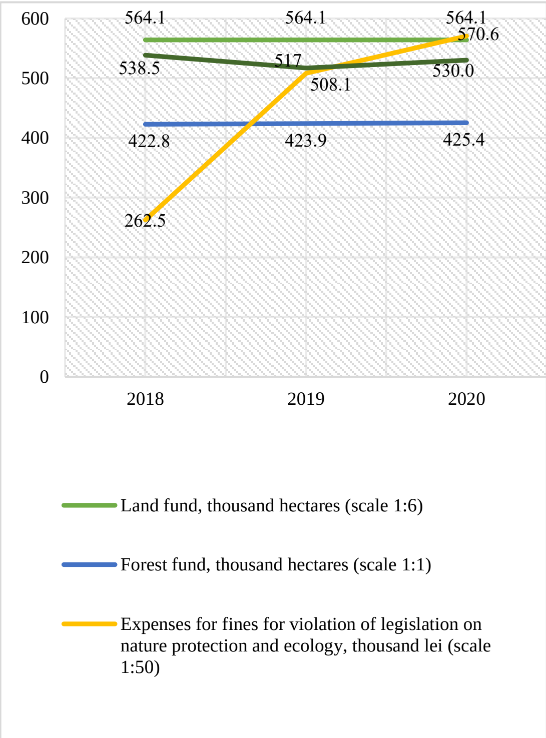

Fig. 3. Diagram of the relationship between the volume of natural resources and expenditures of organizations on their use in the period 2018-2020
Source: Own design.

It becomes clear that the tendency of state support of business as a taxpayer, contributing to the increase of its capital by excluding production costs for natural resources from the cost of production (services), is preserved in the RM. The consequence of this approach is the establishment at the legislative level of principles, procedure of charging and mechanism of payment of fees for the use of natural resources. The issue of compliance of the provisions of the legislative framework of the Republic of Moldova regarding the recognition of natural capital with the requirements of the concept of sustainable development is thoroughly disclosed in the work [7]. In this regard:

-at the micro level - the business unit lacks the motivation to recognize natural capital and assess its contribution to the sustainability of the adopted business model;

-at the macro level - there is no basis for integrating information about the changes in the value of natural capital in the context of maintaining the sustainable development of society.

In addition, the use of this kind of state support for business leads to contradictions with the provisions of the National Strategy ”Moldova-2030” on the transition to the paradigm of socio-economic development. To identify this problem, let us use the question formulated by Mises: is the exemption of owners from liability for environmental damage arising in the course of their activities not the result of a deliberate policy of government and legislators? Or is it an unintended consequence of the traditional wording of laws...? [14, p. 615].

Summing up this part of the study, we emphasize that in the context of EU-Moldova association, the Government of Moldova undertook a number of commitments, including support of natural capital, for the implementation of which the National Development Strategy ”Moldova – 2030” for 2021-2030 was adopted. Nevertheless, the accounting system of RM is oriented to the continental (European) model, according to which the financial statements are prepared on the basis of a legal approach according to the principle of "directivity and clarity", which gives an accurate picture of the financial situation of the reporting organization. This principle is enshrined in the Law № 287 of 15.12.2017. ”On Accounting and Financial Reporting” [12]. As a consequence, the application of the concept of valuation at fair value - a trend of the Anglo-Saxon model of accounting and reporting in the national accounting system of the Republic of Moldova is not yet provided, as well as the transition to the socio-economic paradigm of financial reporting. To be fair, we should note that the General Chart of Accounts of the RM has a separate account 342 ”Subsidies to entities with public property”, which reflects the recognition of subventions received by the entity with their subsequent allocation to increase the charter capital. However, the application of this account for the recognition of natural capital as a contribution to the business of other stakeholders to ensure sustainable development is difficult in the context of the outlined features of the accounting system of RM.

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The above is the justification of hypothesis *H1* - the Moldovan accounting and financial reporting system currently lacks a conceptual space for presenting information about natural capital as a result of the business environment's participation in ensuring sustainable development of society.

Methodological assessment of the recognition of natural capital as an element of financial statements

One cannot but agree with Ageev and other authors of ”Integrated Reporting: A Challenge for Management” that the central point in the evolution of financial and non-financial reporting is the interpretation of the content of the concept of ”capital” [1].

Today it has been proven that natural capital, while differing in form, has a number of economic characteristics typical of financial capital: it is transformed into other forms of capital, brings profits in the future, depreciates in time, requires investment support, affects the total value of a business unit [7]. And, therefore, along with financial capital, information about the state of natural capital and its impact on the amount of total business capital should be reflected in the financial statements.

One of the controversial issues is the development of a mechanism for the recognition of natural capital, the implementation of which is complicated by a number of reasons. These include:

-the problem of identifying a natural phenomenon as an economic event [18];

-the dependence of the validity of accounting records on the formalization of natural capital accounts and individual ecosystem goods and services accounts, which are still incomplete in some countries today and non-existent in others [5];

-limited ability to unify the valuation of each type of capital, due to the fact that capital indicators and methods of measurement are constantly evolving [1].

Let us first try to solve the problem of the identification of natural capital. It is known that when recognizing a particular object of observation as an element of financial reporting, the reporting preparer faces a task of a professional nature - to identify the economic event. The identification of an economic event is one of the compositional elements of modern accounting and reporting methodology, the application of which is considered the first step in generating useful information for users of financial statements.

Recognizing natural capital as an element of financial reporting is a rather complex process. This is due to the fact that it embodies the contribution to business capital of natural phenomena (natural resources and ecosystem services), which should be given economic content. According to the authors, the identification of natural capital consists of going through a three-step algorithm, presented in Figure 4.

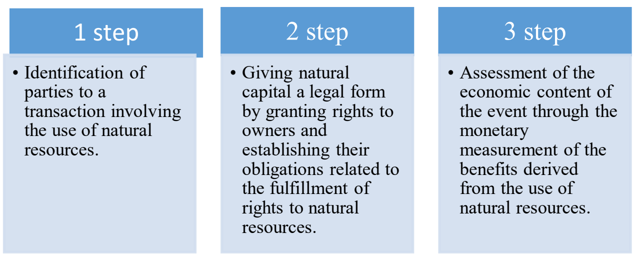

Fig. 4. Algorithm of natural capital identification
Source: Own result.

Let's disclose the essence of each of the stages of the identification algorithm. In this context, one cannot but agree with Ofurum and Ngoke that the function of management, the tool of implementation of which is accounting, includes the identification of stakeholders in the increase in the cost of business capital and the shares of their interests in this increase [16]. Moreover, they emphasized that in the absence of the value of natural capital in the financial statements, the information provided would not meet the needs of stakeholders. And, as a consequence, the actual purpose of the financial statements will not meet the purpose of presentation.

So, according to the legislation of the Republic of Moldova, ownership of natural resources can be public and private. Natural resources that are in private ownership belong to individuals or legal entities by the right of possession, use and disposal, and national resources belong to the state. Private ownership is limited, and the right to own them traditionally belongs to the state [13].

On the basis of various public-private partnership agreements (subsidies, concessions, leases and others) natural resources and their services are transferred by the state to businesses in order to use them effectively and produce quality public services (the first stage of identification, see Fig. 3). By the form of execution, such contracts are a financing mechanism operating on the basis of the pooled capital, consisting of two parts: private (equity) capital and non-private (public) capital. In this case, the state becomes one of the contributors to the aggregate capital of the business.

According to the authors, ownership is of particular importance for the recognition of natural capital as an element of financial reporting, since it is the basis for imposing liability on an economic entity for environmental damage as a result of its activities. We emphasize that this work does not aim at an in-depth study of the concept of "ownership" and refers to it only in the context of forming the evidence base for the recognition of natural capital in the financial statements.

The legal person, having contractual rights in relation to the property, recognizes and obligations associated with its use (*the second step*, Fig. 3). The accounting system then interprets the economic content of the transaction, and, on the one hand, the assets embodying the rights in respect of the property are recognized, and, on the other hand, the liabilities of the legal entity to be fulfilled.

Otherwise, the legal entity neglects the costs associated with the maintenance of this property and does not reflect them in the financial statements. This approach is legitimate because it is a consequence of the implementation in the accounting and reporting system of the concept of property rights. According to generally accepted definition, property right is a set of legally enshrined rights in relation to the property owned by the owner that does not violate rights and legitimate interests of other persons [6]. This practice exists in RM (Fig. 2), and the national accounting and financial reporting system responds accordingly (see justification of hypothesis *H1*).

It is a well-known fact that accounting converts economic events into accounting entries, which in generalized form are accumulated in the financial statements of the economic entity (*the third step* of identification, Fig. 3). One cannot but agree with Pérez-Benedito, who believes that since financial reporting is the synthesis of human activity, it must reflect the value measurement of all the results of this activity, which will contribute to a qualitative assessment of the decisions made [17]. In this context, the valuation of the contribution of natural capital and its changes is one of the problems of modern accounting methodology.

Let us now focus on the problem of the validity of accounting records for natural capital recognition. In this regard, we support Boyd et al.'s view that individual business units' approaches to natural capital summarization can be varied, but they must meet accounting standards [5]. The author's argumentation of the methodological approach to the recognition and accounting of natural capital will be carried out on the basis of the IFRS system, flexibly responding to the requirement of the new development paradigm of transition to the socio-economic model of accounting and reporting.

So, the modern interpretation of capital underlying the Concept of IFRS determines the purpose of financial reporting in presenting useful information to a wide range of users for making effective decisions, and first of all, to investors for their assessment of the use of all economic resources. This does not exclude their interest in reliable information about the interaction between the business and the environment, the influence of this interaction on the increase in the cost of equity or on the change in the value of the business as a whole. As a consequence, the provisions of IFRS provide alternative approaches to the recognition of new forms of capital, which contributes to the development of appropriate accounting methodologies.

According to the accounting methodology, the reconstruction of the economic event associated with the transfer of the right to control, use or receive income from natural resources, it must find its reflection in the financial statements. On the one side, controlled resources (land and natural reserves) are presented in the section ”Assets” as controlled resources, on the other side - the source of their occurrence in the section ”Liabilities”. But as what element of it, capital or liability?

It is appropriate to emphasize that the IFRS methodology on the basis of special standards makes it possible to legitimately solve the problem of recognition of natural capital in reporting in the performance of a number of public-private partnership agreements. However, this study intentionally focuses on the provisions of IAS 20 ”Accounting of Government Grant and Disclosure of Government Assistance” (hereinafter, IAS 20), because the interpretation of its provisions is adequate [10]:

▪ to recognize in the section "Equity" a non-monetary form of government subsidy as a source of obtaining land for the use of the business;

▪ will provide a key to resolving the problem of recognizing natural capital as a source of origin and types of resources such as mineral resources and environmental services.

Because IAS 20 does not prescribe a specific approach to recognizing a government grant, accountants will need to exercise good judgment and common sense to take into account and evaluate all the circumstances that would allow them to clearly identify the grant as either a capital item or a specific revenue item [2, p. 261].

This standard provides for two alternative approaches to the recognition of government subsidies (Article 13): the equity approach, under which the subsidy is recognized outside profit or loss, and the income approach, under which the subsidy is recognized in profit or loss over time, and provides arguments (Articles 14, 15) for each of them [10]. Let's justify the appropriateness of applying the equity method for recognizing natural capital in the equity section of the Balance Sheet in circumstances where a nonmonetary governmental subsidy in the form of a land plot has been provided:

(a)the government subsidy in the form of a non-monetary asset is a financing mechanism through capital pooling and should be recorded in the Balance Sheet;

(b)on the basis of ownership, no repayment of the subsidy is expected, although the granting of the subsidy provides for the performance of certain obligations;

(c)ownership of the transferred asset is vested in the government, which makes a contribution to the aggregate capital of the business similar to that of the shareholders;

(d)finally, the government subsidy in the form of a non-monetary asset represents an incentive for the business unit to carry out operational activities whose vector is social in nature, with which no income or expense is associated.

In accordance with the above:

(1) consider it incorrect to recognize the non-monetary form of the state subsidy (land plot) as deferred income, the main purpose of which is to reflect information on changes in the state of monetary assets;

(2) we propose to open formal accounts: "Funding under public-private partnership agreements," used for initial recognition of a non-monetary form of subsidy and with its subsequent closure to Equity accounts; "Other forms of capital," subaccount "Natural capital under public-private partnership agreements," used for recognition of natural capital;

(3) and finally, we propose to modernize the structure of the Statement of Changes in Equity to present information on recognized natural capital and the reasons for changes in its condition.

As a consequence, we can state that the proposals put forward on the application of three-stage identification and formalized accounts are part of the methodology of natural capital recognition. Its second part, the assessment of natural capital, is a debatable issue and is subject to further study.

The results of this part of the study substantiate hypothesis *H2* - the adequacy of IFRS methodology for the recognition of natural capital as an element of financial statements. Moreover, the authors propose improved methodological techniques for the recognition of natural capital: an algorithm for its identification and the opening of special accounts.

CONCLUSIONS

In this study, hypotheses were put forward and argued, resulting in a general conclusion: the recognition of natural capital as an element of financial reporting is an imperative of the socioeconomic reporting paradigm. Particular conclusions of the study include:

(1) the tendency of state support of business as a taxpayer, which contributes to the increase of its capital at the expense of the depreciation of natural capital, remains in the RM;

(2)the national accounting and reporting system lacks the conceptual space for the recognition of natural capital as a result of business environment participation in the sustainable development of society, which predetermines its modernization;

(3) the IFRS methodology of applying the equity method to recognize the non-monetary form of the grant is effective for recognizing natural capital as an element of the financial statements.

The result of the applied part of the work are proposals to improve the methodological techniques for the recognition of natural capital: a three-step algorithm for identification and reasoned opening of a special account.

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