Assurance insights

Understanding double materiality

Board Leadership Center

Boards play a pivotal role in sustainability reporting and assurance. Their oversight and strategic direction help ensure that the company's sustainability initiatives align with long-term goals and meet regulatory and stakeholder expectations.

The concept of Double Materiality, introduced under the EU's Corporate Sustainability Reporting Directive (CSRD), broadens the scope of materiality assessment to include both financial impacts on a company and the company's impacts on society and the environment. This approach can help ensure that Boards aren't only aware of potential financial risks and opportunities but also how their activities may actually or potentially impact people or the environment.

This article aims to demystify what double materiality means and offers a series of questions Boards may consider as they think about starting a Double Materiality Assessment.

Understanding Double Materiality

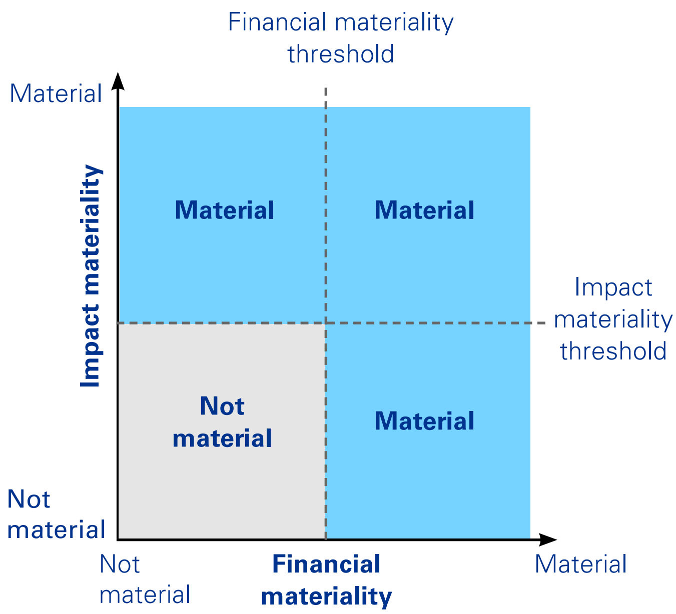
The concept of double materiality drives the content of a sustainability statement. Companies make materiality judgements to focus their reporting on information that is relevant to their specific facts and circumstances, rather than simply providing a prescribed list of disclosures.

Double Materiality refers to the two-dimensional approach[1] of materiality — 'financial' and 'impact'. Companies in scope for CSRD will need to perform materiality assessments for both and report matters that are material in either or both dimensions as well as considering the interrelationship between the two.

It's important to note that the definition of financial materiality under the European Sustainability Reporting Standards (ESRS) is aligned with the definition of materiality under IFRS® Sustainability Disclosure Standards. However, there is no equivalent 'impact materiality' requirement under IFRS Sustainability Disclosure Standards, although companies would need to provide information about their impacts where it is financially material.

The process a company undertakes to identify its material 'impact risks and opportunities (IROs) is referred to as the **Double Materiality Assessment (DMA)**

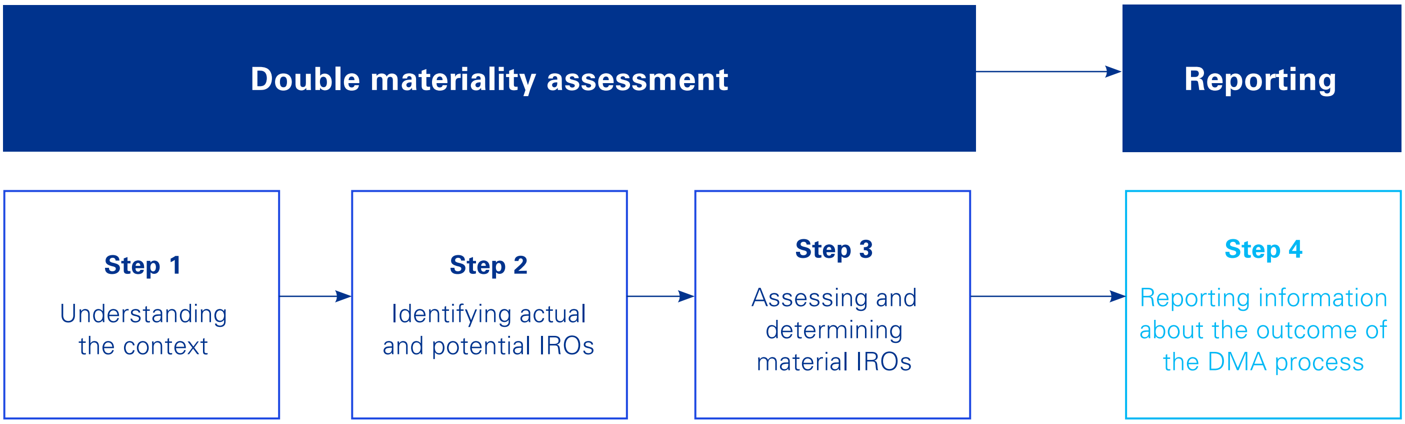
Double materiality two-dimensional approach



[1] ESRS Foundations — Insights into sustainability reporting, KPMG IFRG Limited, November 2024

Application of Double Materiality for companies

In performing the DMA, a company is required to consider both financial and impact materiality, as well as the interconnections between the two. However, it is not required to design two separate processes. Companies are required to design a process for their specific circumstances. European Financial Reporting Advisory Group (EFRAG) Materiality Assessment Implementation Guidance illustrates the steps a company might take.



Impact Materiality: A sustainability matter is material from an impact perspective when it could have an actual or potential impact (positive or negative) on people or the environment over the short, medium, or long term. This includes impacts from the company's own operations and those connected with its value chain and business relationships. For example, a company operating in a water-stressed area must consider the impact of its water usage on local communities and ecosystems.

Assessing impact materiality depends on the severity of the impact and, for potential impacts, the likelihood of occurrence. Severity is determined based on the characteristics of scale, scope and, for negative impacts only, if and to what extent impacts could be remediated. Although the characteristics are often interdependent, any of the three characteristics can make a negative impact severe. It is important to note that when considering a potential negative impact on human rights, the severity of the impact takes precedence over its likelihood of occurring.

Financial Materiality: A sustainability matter is financially material when it triggers (or could reasonably be expected to trigger) material financial effects on the company. It considers risks and opportunities that may influence the company's financial position, performance, cash flows, access to finance, or cost of capital. For example, new environmental regulations could pose a financial risk by increasing operational costs or limiting access to essential resources.

Importantly, financial materiality is assessed based on whether the information is considered useful for the primary users of general purpose financial reports (e.g. investors, lenders) in making decisions about providing resources to the company — i.e. information is considered material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that users make on the basis of a company's sustainability statement.

Financially material information may relate to sustainability-related risks or opportunities arising from the company's:

- **dependence** on a natural or social resource (e.g. a raw material or labor) that its prospects depend on;
- **negative impacts on stakeholders**, which in turn affect the company's prospects (e.g. by becoming subject to stricter regulation or by harming its reputation); or
- **business relationships** (e.g. consequences when business partners face material sustainability-related risks).

Companies assess materiality of risks and opportunities based on a combination of the **likelihood of occurrence** and **potential magnitude** of the financial effects.

Current regulatory environment

A two-year postponement in mandatory reporting under ESRS and EU Taxonomy for second- and third-wave companies in scope for CSRD has been agreed by the EU under the 'Stop the clock' directive.

The Commission has also mandated EFRAG to amend ESRS to substantially reduce the volume of disclosures, however the concept of Double Materiality will remain. **Now is a good time for companies to identify any 'no-regret moves' including reprioritizing efforts and focusing on strategic actions that go beyond compliance.**

Board considerations and 'no regret' moves

Embracing the concept of double materiality means adopting a more holistic approach to decision-making. It involves integrating sustainability considerations into strategic planning, risk management, and performance evaluation. This shift is not just about compliance or reputation management; it is about recognizing that long-term value creation is inherently linked to sustainable and responsible business practices.

To effectively navigate the complexities of a Double Materiality Assessment, Boards and senior executives will need to ensure that their governance structures are equipped to handle the expanded responsibilities. Regular training on sustainability issues and effective stakeholder engagement will be necessary to understand the materiality of sustainability issues from both financial and impact perspectives.

Independent assurance brings credibility to a company's DMA by providing an objective evaluation. This external validation ensures that the assessment complies with relevant sustainability standards and frameworks, reinforcing the company's commitment to sustainability and responsible business conduct. Ultimately, independent assurance, whether mandatory or voluntary, helps build trust with stakeholders, including investors, customers, and employees, by demonstrating the accuracy and reliability of sustainability reporting.

With the first year of CSRD reporting behind us, Boards should consider conducting benchmarking assessments against material sustainability matters identified by peers in their sector. By comparing their performance and strategies with their peers, they will be able to identify best practices, uncover potential areas for improvement, and ensure their sustainability efforts are not only effective but also aligned with broader industry standards.

As Boards and senior executives consider their approach, they should reflect on several key questions to help ensure their strategies are robust, comprehensive, and aligned with long-term value creation.

Questions to consider

1. How does our organization define and differentiate between financial materiality and impact materiality in the context of our sustainability strategy?
2. What are the key sustainability matters that could have a material impact on our business operations, and how do they align with our overall business objectives?
3. How do our activities impact society and the environment, and what are the potential positive and negative consequences over the short, medium, and long term?
4. What processes and methodologies will we use to perform the Double Materiality Assessment (DMA), and how will we ensure they are tailored to our specific circumstances?
5. How will we engage with internal and external stakeholders to gather input and feedback on material sustainability matters, and what benchmarks should we set?
6. What are the key risks and opportunities identified through the DMA, and how will they influence our sustainability reporting and decision-making processes?
7. How will we ensure that our sustainability disclosures are aligned with the European Sustainability Reporting Standards (ESRS) and other relevant regulatory requirements?
8. What governance structures and oversight mechanisms do we need to put in place to monitor and review the outcomes of the DMA and ensure continuous improvement?
9. How will we communicate the results of the DMA to our stakeholders, including investors, employees, customers, and the broader community?
10. What resources and capabilities do we need to build or enhance within our organization to effectively conduct and leverage the insights from the DMA?

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