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Corporate Sustainability Reporting: What Is Double Materiality and Why Is It Important?

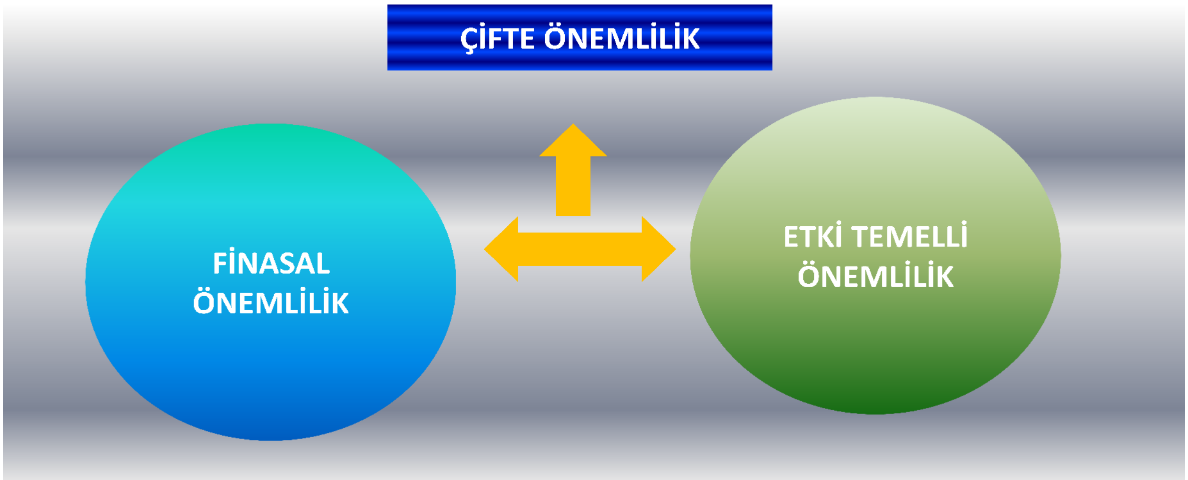
For the European Union, the objective of becoming the world's first climate-neutral continent by 2050 is of critical importance. To this end, within the scope of the European Green Deal Action Plan, the European Commission has accelerated and tightened transformative policies and the accompanying legal regulations. Moreover, due to companies' failure to adequately fulfil their due diligence obligations under long-standing voluntary practices, the Commission has in recent years either revised many directives or reinforced them with new ones, integrating them into its overarching objective. In some areas, it is even planning to introduce punitive sanctions.

On the other hand, finance plays a key role in this transformation and climate adaptation process. In order to accelerate the transition to a decarbonised economy, properly manage sustainable finance flows, and enable investors to make informed decisions, there is a need for transparent, simple, and greenwashing-free sustainability reporting, and legal regulations are evolving in this direction. Therefore, corporate sustainability reports, in which companies disclose their environmental, social, and governance (ESG) performance, are of great importance in this transformation and are expected to be presented together with financial reports in the near term.

Within this framework, double materiality, which plays a critical role in identifying risks and opportunities for companies, is at the core of corporate sustainability reporting. In order to properly understand their reporting obligations, companies need to adopt the double materiality approach, which is a prerequisite for accountability and covers the entire value chain.

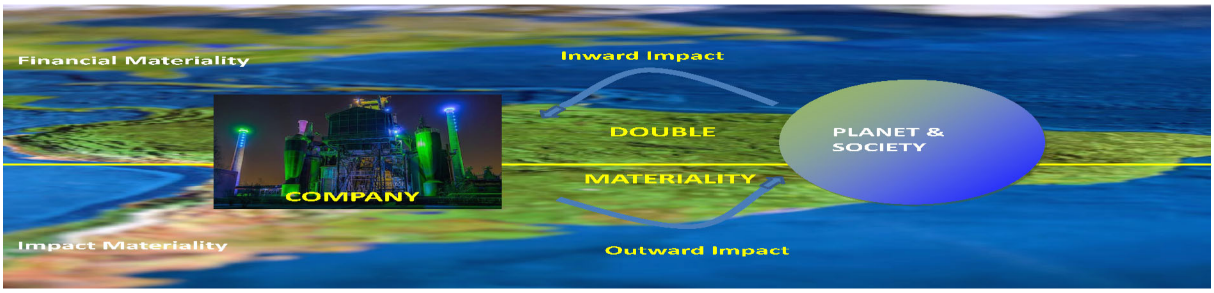
The concept of double materiality was first introduced in 2019 within the additional set of rules titled “Guidelines on Reporting Climate-Related Information,” published by the European Commission under the Non-Financial Reporting Directive (NFRD). Accordingly, materiality assessment was defined as consisting of both financial and impact-based perspectives. The Council announced the final approval of the Corporate Sustainability Reporting Directive (CSRD), which amends the NFRD, on 28 November 2022. Under the Directive, reporting requirements will be implemented gradually for different types of companies: from the 2024 financial year for large public-interest entities with more than 500 employees; from 2025 for companies with more than 250 employees or a turnover exceeding EUR 40 million; and from 2026 for listed SMEs (which may prepare reports on a voluntary basis until 2028). In addition, certain large non-EU companies operating in the EU will also fall within the scope of the Directive.

The European Commission has tasked the European Financial Reporting Advisory Group (EFRAG) with the development of the European Sustainability Reporting Standards (ESRS). For this purpose, EFRAG published the first set of 12 draft European Sustainability Reporting Standards in November 2022. Double materiality constitutes the foundation of this reporting framework.



As is well known, materiality is a key principle in accounting and auditing and is defined as information whose omission, misstatement, or error could reasonably be expected to influence the decisions of users of financial statements. In other words, materiality is a criterion for determining whether information should be included in financial statements, and if not managed properly, it has the potential to result in negative outcomes. According to EFRAG, double materiality consists of the combination of financial materiality and impact materiality perspectives. It is stated that financial and impact-based materiality assessments are interrelated and that the interconnections between these two dimensions should be taken into account.

Under financial materiality, a sustainability matter is considered material if it affects or is expected to affect the company's risks and opportunities in any area that has an impact on access to finance, such as performance, position, development, or cost of capital. Impact materiality, on the other hand, is considered material if the company has actual or potential positive or negative impacts on the environment and society in the short, medium, or long term, either through its own operations or via its value chain. Accordingly, double materiality refers to the assessment of materiality that simultaneously considers both the risks and opportunities arising from sustainability-related impacts on the company (outside-in perspective) and the impacts of the company's activities on the environment and society through its direct operations or indirectly through its entire value chain (inside-out perspective).



For example, let us assume that a company discharges chemicals into the sea or soil in an uncontrolled manner, creating potential threats to biodiversity, local livelihoods, or public health (the company's impacts on external factors). As a result, potential risks such as fines, shutdowns, or compensation arising now or in the future due to regulatory violations would represent losses and damages originating from external sources (the impacts of external factors on the company). As seen, risks are two-sided (inside-out and outside-in), materiality types are not independent of each other, and they must be included in reports. If a decision is made not to include them in reports on the grounds that they are not material, the reasons for this decision must be disclosed. Since traditional materiality assessments do not sufficiently consider very long time horizons, the Standard recommends placing long-term ESG risks at the centre of analysis.

Materiality assessments form the basis for companies to develop robust sustainability strategies and for stakeholders to be informed about sustainability performance. In addition, organisations gain a better understanding of all dimensions of business performance, contribute more effectively to the Sustainable Development Goals, better address stakeholder expectations, facilitate the efficient use of resources, and support outcomes such as employee engagement. Identifying and reporting information or sustainability topics with significant impacts—by assessing their likelihood of occurrence, scope, and short-, medium-, and long-term effects on all stakeholders, the environment, and society—is critical.

The double materiality assessment process consists of the following steps:
a) Identification and updating of priority topics,
b) Collection and evaluation of evidence demonstrating both financial and impact materiality,
c) Engagement with internal and external stakeholders, including the board of directors, regarding the identified and assessed matters,
d) Reporting and assurance of the process and results,
e) Effective monitoring of priority topics.

Briefly addressing prioritisation processes, the most significant challenge encountered during assessment is determining what is material—that is, correctly identifying potential internal and external risks and impacts. Ensuring that no future issue is overlooked is the most important step for reliable and high-quality reporting. Financial materiality assessment, which is already in practice, is relatively clearer and is primarily evaluated from the perspective of a limited stakeholder group such as investors and creditors. However, in impact-based materiality, the ecosystem is broader and a wide range of stakeholders, from employees to NGOs, must be taken into consideration. Evidence supporting the analysis should include legal regulations, regional and sectoral requirements and practices, geopolitical context, global developments, markets, and technological advances. In addition, since both the current CSRD and the draft Corporate Sustainability Due Diligence Directive (CSDDD) refer to guiding principles with which they interact closely in line with their core objectives—such as the United Nations Guiding Principles on Business and Human Rights (UNGPs), the OECD Guidelines for Multinational Enterprises, and the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy—these principles should not be disregarded.

Naturally, the disclosed information must be aligned with the Taxonomy Regulation and the relevant delegated acts referenced in these guiding principles. Moreover, the participation of the board of directors and senior management is of great importance in the stakeholder engagement process. Following the reporting of prioritised topics, the next critical step is monitoring. In order to avoid exposure to risk when obligations arise in relation to previously disclosed topics, it is essential to integrate prioritised topics into risk monitoring tables and establish systems capable of conducting dynamic process assurance. Considering technological solutions is therefore a key aspect of high-quality sustainability reporting.

On the other hand, when EFRAG's explanations on double materiality under the European Sustainability Reporting Standards are compared with those of leading standard-setting bodies, it is noted that the International Sustainability Standards Board (ISSB) and the U.S. Securities and Exchange Commission (SEC) are not yet fully aligned on this matter. Nevertheless, there is a consensus on the development of globally consistent reporting. While the SEC and ISSB currently focus on financial materiality, the ISSB's cooperation with the Global Reporting Initiative (GRI) indicates potential future progress in the area of materiality. Although the Task Force on Climate-related Financial Disclosures (TCFD) adopts only a financial materiality perspective, its role in climate-related disclosures remains critical. Ultimately, all standards are expected to be assessed and reported in a way that provides investors with the sustainability information they need from an investor-focused perspective.

Within the scope of the European Green Deal Action Plan and the Sustainable Finance Action Plan, the European Commission continues to present packages of measures aimed at establishing sustainable growth, with issues becoming clearer as detailed technical standards are published. Both investors and other stakeholders, including NGOs and trade unions, are now demanding more information on companies' ESG performance. As an integral part of the Green Deal, the CSRD introduces a dual-perspective approach to materiality and presents an ESG materiality concept. Accordingly, in order to gain insight into a company's actual performance, sustainability-related topics must be reported by conducting materiality analyses that holistically consider both the financial impacts on the company and the impacts of company activities on ESG factors. When global developments are taken into account, it can be stated that reporting standards shape financial markets and industry in the construction of a sustainable economy, while at the same time continuing to evolve.

([1]) *For further information on the CSRD, please refer to our magazine column dated 11 October 2022.*

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