WHITE PAPER

The New Double Materiality Assessment

A Toolbox for Companies

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By Lorenzo Fantini, Jannik Leiendecker, and Benedetta Testino

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The New Double Materiality Assessment:

1 Why materiality assessment is a must for companies

Customers, investors, and employees are demanding more and more transparency from large companies about their commitment to activities that fall under the Environmental, Social, and Governance (ESG) umbrella—including, but not limited to, climate change transition, responsible business practices, access and affordability, and community engagement.

A materiality assessment **provides companies with a tool to capture stakeholders' perspectives on ESG, sets a course, and indicates where future investment may be required.** In essence, it is a stakeholder's discovery journey that helps prioritize topics for investment and resource allocation.

The output of a materiality assessment is a matrix clustering of ESG topics in which companies can make the most difference or can enable ESG transformation, or which should just be monitored for compliance from the perspective of key stakeholder groups.

While materiality assessment is an established market practice[1] among large European financial institutions already reporting on most material ESG topics in their sustainability reports, this tool has been developed as a regulatory requirement under the EU Corporate Sustainability Reporting Directive (CSRD). This new directive will come into force with a phased approach starting January 2024, and requires EU companies[2] to apply new double materiality to identify their material ESG topics to meet appropriate disclosure requests.

CSRD double materiality, which introduces the concept of materiality of the company's activities on its environment and ecosystem (the society perspective) in addition to financial materiality (the investor perspective), perfectly **exemplifies the effort to serve society at large** with a wider remit.

CSRD is not the only effort to consolidate ESG international standards. The International Sustainability Standards Board (ISSB) Committee, established by the International Financial Reporting Standards (IFRS) in 2021, has developed its own global standards promoting a different approach to ESG reporting. Whereas ISSB standards are principles-based, with some room for flexibility for companies, and are climate-centric and strictly directed to investor protection, CSRD is more prescriptive, covers the full range of environmental, social, and governance topics beyond climate, and goes beyond investor protection.

2 A shifting regulatory landscape

The CSRD is a "2.0" armored version of EU Non-Financial Reporting Directive, that improves the quality, scope, and accessibility of sustainability reporting.

The European Financial Reporting Advisory Group (EFRAG) is a wing of the EU Commission on CSRD, empowered to serve as technical advisor to develop the European Sustainability Reporting Standards (ESRS) disclosure requirements with which companies need to comply.

1. Introduced for the first time in the 2019, EU Commission Guidelines on non-financial reporting: Supplement on reporting climate-related information
2. CSRD will apply to all EU companies, that is, EU companies exceeding at least two of the following criteria:
   — more than 250 employees;
   — a turnover of more than €40 million; or
   — total assets of €20 million
   Also applies to non-EU undertakings with annual EU-generated revenues in excess of €150 million

The formulation for EFRAG's new double materiality tool is under ESRS 1 "General requirements," and is defined as the union of impact and ¬financial materiality—how sustainability matters affect the company's position and how the entity itself impacts the environment and society at large.

In practice, CSRD's expectation is that all ESG topics (climate change, biodiversity, workforce in the supply chain, business ethics) must be disclosed to ESRS. Any exceptions to this rule must be justified with a "comply or explain" approach. The materiality assessment serves as a filter to identify industry- or entity-specific ESG topics which are not material (both from a financial and impact materiality perspective) for a corporation, and as such can be excluded from ESRS disclosure, if appropriate facts and reasoning are given.

(See Exhibit 1)

Impact materiality, the new principle introduced by CSRD, concerns the actual or potential impact of a particular sustainability topic on people or the environment over short, medium, and long time horizons. Issues caused or contributed to by the company, and those which are directly linked to the company's value chain, must be included.

EFRAG further elaborates that potential impact of materiality includes both likelihood and severity of an impact. The severity of negative impacts is the result of scale (how grave the impact is, whether it links to non-compliance with laws), scope (how widespread the impact is, the number of people negatively affected) and the irremediable character of the impact (whether and to what extent the negative impact can be remediated).

Financial materiality, a well-established way of looking at reporting also adopted by the ISSB, concerns the material financial effects of certain sustainability matters on the company. This would be the case when a sustainability matter generates a material effect on cashflows, development, performance, position, cost of capital, or access to finances in the short-, medium-, and long-term, beyond the scope of the consolidation used in the preparation of financial statements.

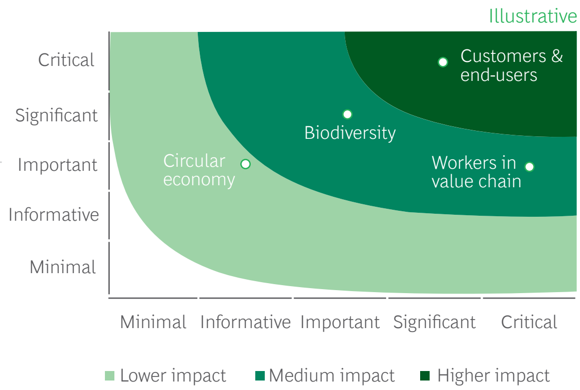
Exhibit 1 - EFRAG Double Materiality Assessment in A Nutshell

"Double materiality assessment is a tool providing criteria to determine if a sustainability topic or information must be included in the sustainability report. A sustainability topic is "material" when it meets the criteria defined for impact materiality, financial materiality, or both"

Impact materiality
(impact of Client Group)

Actual or potential, positive or negative impacts on people or the environment over the short, medium, or long-term.

Includes impacts directly caused or contributed to by the undertaking and impacts which are otherwise directly linked to the upstream and downstream value chain (e.g., supply chain, products, services), not limited to direct contractual relationships



Financial materiality
(impact of Client Group)

Generated risks or opportunities that influence or are likely to influence the cash flows, development, performance, position, cost of capital, or access to finance in the short, medium-, or long-term, but are not captured by financial reporting.

A sustainability matter is material if it triggers or may trigger material financial effects

Source: European Financial Reporting Advisory Group (EFRAG] European Sustainability Reporting Standard 1 (November 2022); Double materiality conceptual guidelines for standard-setting.

While EFRAG specifies the “ingredients” necessary to substantiate impact and financial materiality, it does not elaborate on specific aggregation mechanisms and respective thresholds, leaving room for companies to define and disclose their own methodology in reporting.

With no additional granular guidelines provided, limited or no market experience, and two years to comply, companies embarking on EFRAG double materiality for the first time might feel some practical points are unresolved.

The following chapter provides a BCG perspective on how to implement a double materiality assessment, moving from theory to practice, and suggesting actionable answers to questions not yet formally addressed, while future regulatory guidance needs to be monitored.

3 A BCG playbook on responding to new double materiality

In our experience, companies need to solve five key questions when approaching double materiality for the first time.

1. **WHEN to run the double materiality assessment**

2. **WHERE to start** (**with which ESG topics**)

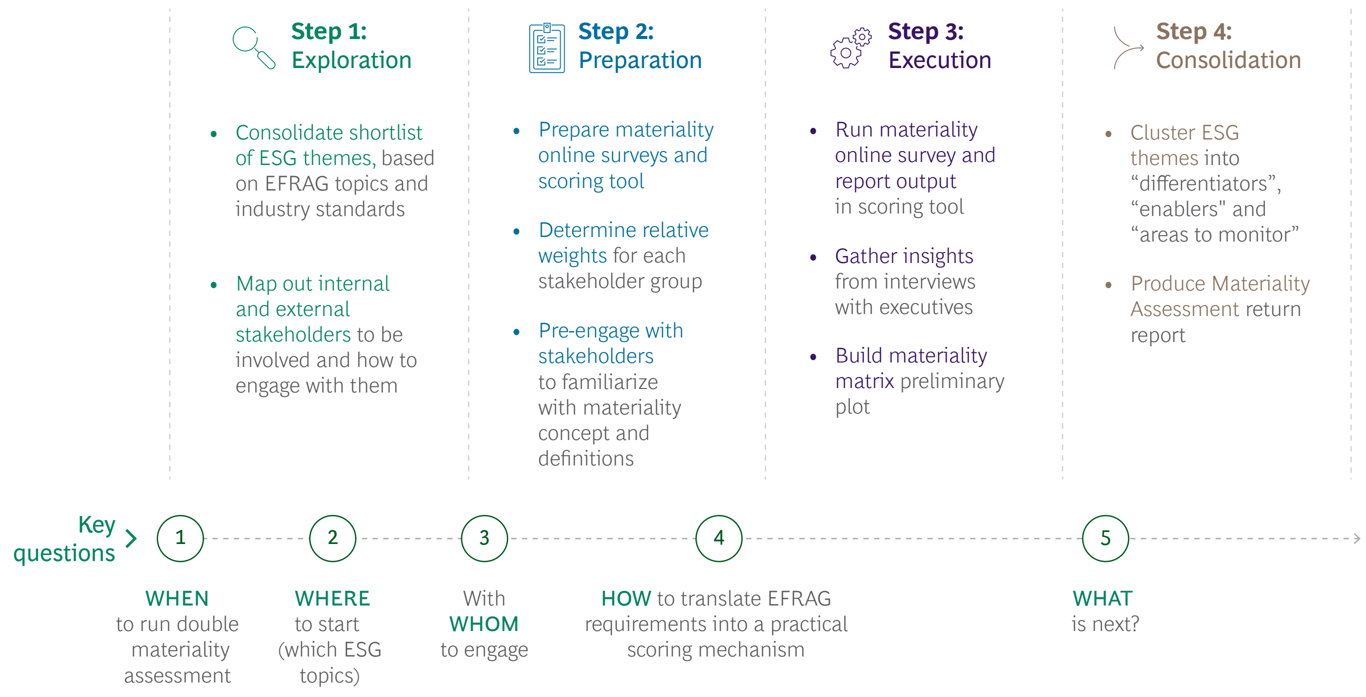
3. **With WHOM to engage**

4. **HOW to translate EFRAG requirements into a practical scoring mechanism**

5. **WHAT is next, how to read the materiality matrix**

(See exhibit 2)

Exhibit 2 - BCG’s four-step materiality assessment approach to answering key questions unaddressed by current regulation



3.1 WHEN to run the double materiality assessment

While sustainability reporting is an annual obligation for EU companies, there is no strict requirement for how frequently to run the double materiality assessment.

As a matter of fact, today many large EU companies are performing a full materiality assessment every two to three years, when refreshing their own ESG strategy, along with continuous monitoring by strategy, sustainability, compliance, and risk management to determine whether non-material issues might become material for the business over time. We believe this trend will continue when the CSRD is fully enforced.

3.2 WHERE to start (with which ESG topics)

In its 2022 ESRS 1 General requirements, EFRAG provides a minimum set of ten sector-agnostic ESG topics (climate change, pollution, water and marine resources, biodiversity, circular economy, etc.) which companies, regardless of their sectors, are expected to include in their own materiality assessment.

Companies should take these as a starting point as they determine what additional information they should disclose and which of these ESG topics are relevant for their organization, taking into account business context and specific circumstances.

Certain topics might not be relevant for certain companies (for example, marine resources for insurance companies), while others, not specifically accounted for by EFRAG, could be (such as aging population or changing demographics for insurance companies).

Companies typically report 15 to 20 ESG topics in their materiality matrix. In BCG's view, companies should consider the following additional inputs when defining their own entity-specific shortlist of ESG topics:

- **Consulting internal and external subject matter experts** across a full range of sustainability topics and business stakeholders, referencing multiple sources (such as mandatory regulatory requirements, market trends and best practices, recommendations from voluntary policies, and online news and media)

- **Market research** into the current use of ESG topics and sustainability indicators by peers (such as the SASB materiality map)

When a company concludes that a topic is not material and therefore it omits from the Disclosure Requirements, that company should provide a brief explanation of the conclusions of its materiality assessment in the management report.

3.3 With WHOM to engage

Mapping which stakeholders to engage with is a crucial step in ensuring the materiality assessment output reflects the actual and forward-looking risks and opportunities for the company.

EFRAG describes two types of stakeholders—those affected by the company, and users of sustainability statements—without specifying who these parties are in a company's ecosystem, how to engage with them, or how to weigh their relative contributions to materiality assessment.

We believe that "affected" stakeholders should, for the most part, contribute to impact materiality, while "users" should contribute to financial materiality, with some stakeholder groups (like employees, top management, equity investors) contributing to both dimensions.

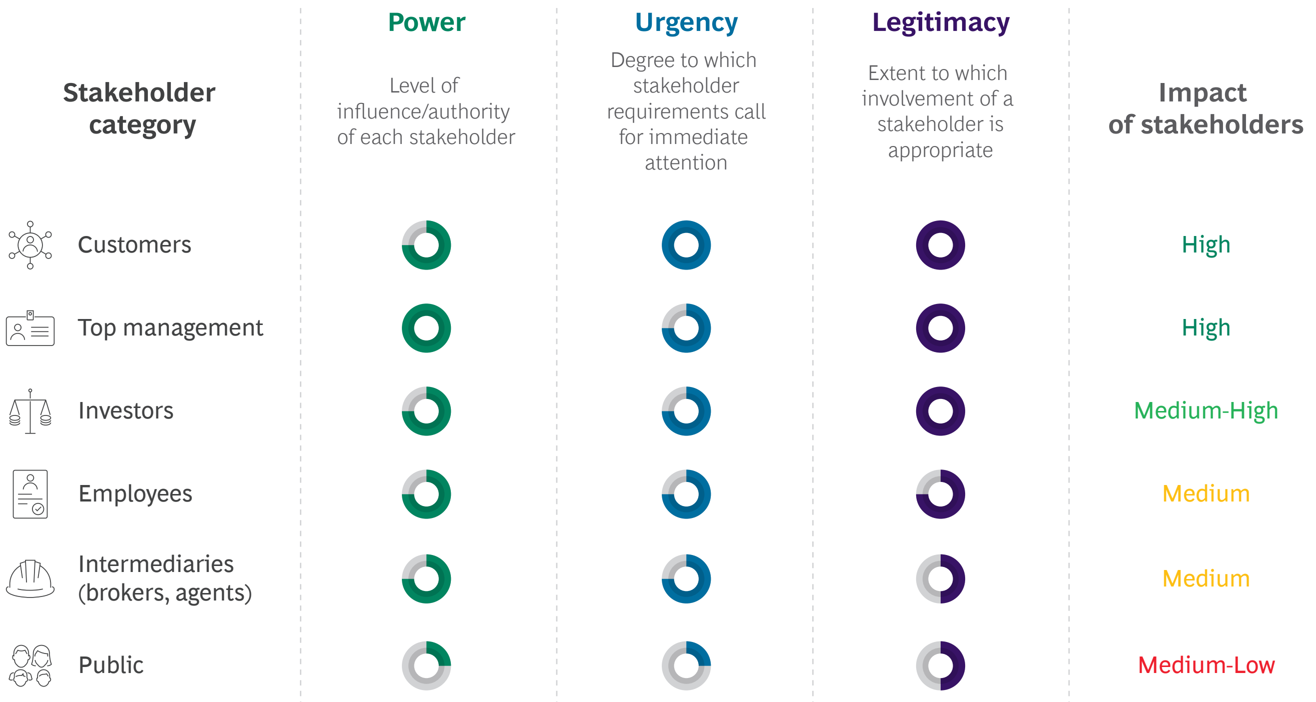
Once stakeholders are mapped out, it will be necessary to calibrate their respective contributions to impact and financial materiality. We found the "Salience model," categorizing stakeholders' claims of power, urgency, and legitimacy, to be a practical tool to weigh the relative contributions of different stakeholder groups. (See Exhibit 3.) While relative contribution is company-specific, top management and customers are typically valued the most.

How a company engages with stakeholders will vary based on the group's reach and proximity to the company.

Top management should be engaged in one-on-one interviews, giving them the opportunity to react to fact-based data points about the actual and potential impact of shortlisted ESG topics and elaborating on how the company's overarching strategy might be affected. As for customers and intermediaries, they should be reached with online surveys composed of a limited number of simple, guided questions.

What is important is that stakeholders are provided with clear and pragmatic guidelines and are equipped with examples and data points to substantiate their own theses.

Exhibit 3 - Salience Model to weigh relative contribution of different stakeholder groups



Source: Salience model; BCG project experience with global insurer.

3.4 HOW to translate EFRAG requirements into a practical scoring mechanism

As stated above, while EFRAG specifies the “ingredients” needed to account for and substantiate impact and financial materiality, it does not elaborate on aggregation mechanisms and thresholds, leaving room for companies to define their own scoring logic.

We typically recommend **a one to five scale (from “minimal” to “critical”), as originally suggested in the January 2022 “Draft ESRG 1 Double materiality conceptual guidelines for standard-setting” for EFRAG Sustainability Standards Board application, in order to collect and codify inputs from different stakeholder groups** (such as data points from online surveys or qualitative statements captured in top management interviews).

Since the scale, scope, and remediability of impacts are not easy factors to understand and measure, especially for those affected stakeholders not familiar with ESG risk management or reporting in their daily lives, these factors could be embedded in a qualitative scale of evaluation or assigned to a subset of knowledgeable stakeholders.

In addition, EFRAG suggests that companies should focus their assessment on areas where ESG topics are deemed likely to arise based on the nature of their activities and business relationships. In practice, we translated this indication into an “adjustment” to the weight of ESG topic financial materiality, while considering the company’s business operating model. ESG topics have different levels of penetration in the organization: some ESG topics are spread and mappable across the whole value chain (like climate change) others are not (responsible products, circular economy, biodiversity). This could be accounted for as an adjustment factor in financial materiality.

Finally, the model-output scores assigned to each ESG topic might be subject to manual overrides based on process documentation and rationales grounded in facts, and causes gathered during the assessment phase (such as new business offerings or shutdown of operations in certain geographies).

3.5 WHAT is next, how to read the materiality matrix

Once company-specific topics have been plotted into a five by five level materiality matrix, companies need to determine:

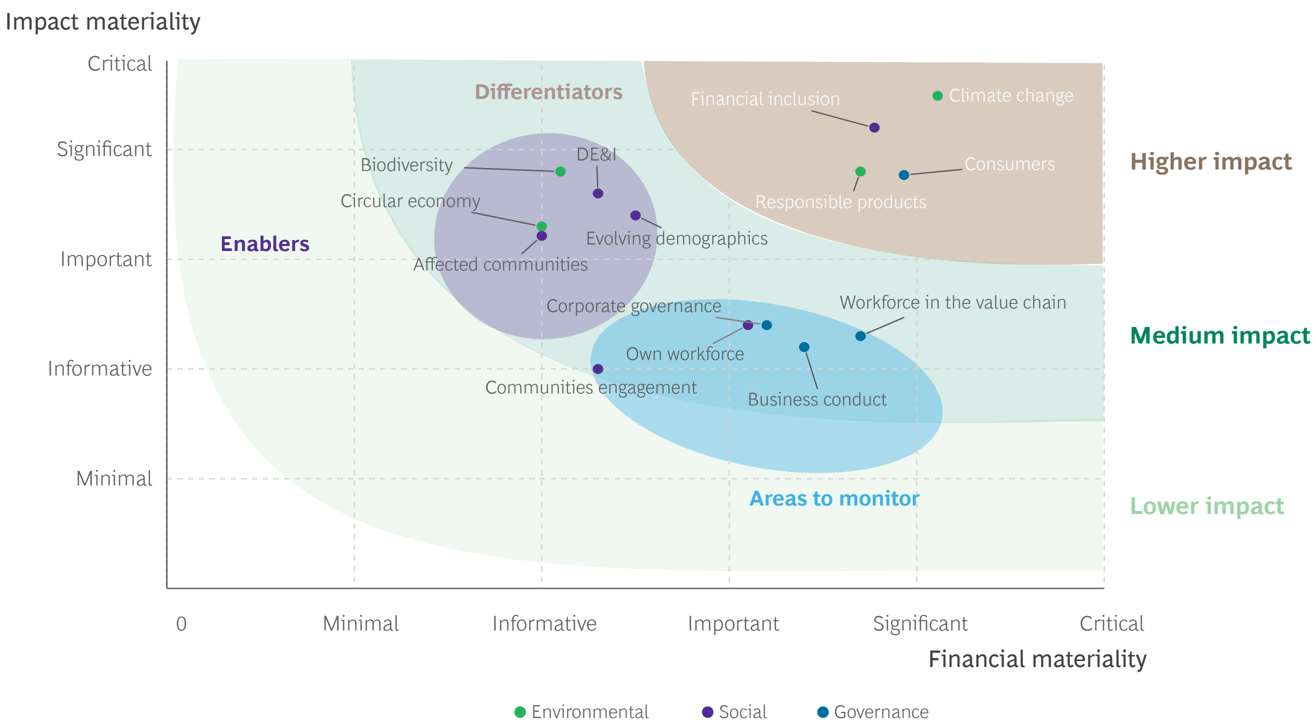
- **Eligible topics for sustainability reporting,** not exceeding predefined cutoffs, from a CSRD compliance standpoint
- **“Differentiator” topics to double-down on,** for future ESG strategy development

As a practical indication, all ESG topics landing into the lower left of the matrix (informational or minimal topics) should not be eligible for reporting, as they do not meet the materiality threshold for both dimensions.

Companies should cluster material ESG topics into three managerial groups to identify the right course of action in a future ESG strategy. (See exhibit 4.)

1. Differentiators: Two to three topics to focus on with accelerated time to market, in line with the company’s purpose and business strategy objectives (such as longevity for a pension provider).

Exhibit 4 - Double Materiality Assessment matrix in practice



2. Enablers: Other ESG topics that might serve as enablers for business transformation (circular economy for a P&C player) and are looked at as the next order priority for future developments.

3. Areas to monitor: "Table stakes" topics that companies need to comply with, without playing a differentiating role in business strategy (business conduct or corporate governance).

4 Getting double materiality right the first time

Large EU companies have less than two years to comply with new EFRAG disclosure standards implementing the concept of double materiality. With limited granular guidelines provided and no market experience, companies embarking on EFRAG double materiality might find a certain number of practical points unresolved. In this context, a few frontrunner companies are taking the initiative and developing their own scoring methodology and approach to meet authorities' expectations.

This paper is a sanitized and structured summary of BCG experience in supporting large European companies, aiming to provide a perspective on how to implement a double materiality assessment and suggesting pragmatic answers to questions not yet formally addressed, while waiting for possible additional regulatory guidance.

Companies embarking on EFRAG double materiality put themselves in a unique position to provide input on the new rules as the European Sustainability agenda evolves, as well as finding the right balance between meeting regulatory expectations and limiting the burden of compliance on the business.

About the Authors

Lorenzo Fantini is a Managing Director and Partner in the Milan office of BCG. He is the Global Topic Leader for Climate & Sustainability in Insurance and for ESG Risk Management and Compliance.

Jannik Leiendecker is a Partner and Associate Director in the Munich office of BCG. He is responsible for ESG Compliance and co-leader of BCG's Climate & Sustainability Policy and Regulatory Center.

Benedetta Testino is an Associate Director in the Milan office of BCG and is a core member of the Climate & Sustainability and ESG Risk Management & Compliance practices.

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For Further Contact

If you would like to discuss this report, please contact the authors.


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