Demystifying the ESRS Approach to Materiality

Many organisations are still unclear on what the Double Materiality requirement in the Corporate Sustainability Reporting Directive (CSRD)1 is all about; how to undertake the assessment; and how it impacts reporting. In answer to these questions, on the 31st of May 2024, the European Financial Reporting Advisory Group (EFRAG)1 released its Implementation Guidance for Double Materiality, called "EFRAG IG1 Materiality Assessment".

The document has been published following several iterations and is intended to be used in conjunction with the European Sustainable Reporting Standards (ESRS)1. These standards detail the rules and requirements for company reporting and underpins the CSRD legislation. The ESRS oblige companies to take a perspective of 'double materiality' in its reporting, considering how a business is financially impacted by ESG topics (Financial Materiality) as well as how the business' activities impact both the environment and people (Impact Materiality). This is often called the 'outside-in' and 'inside-out' approach.

The ESRS Approach to Materiality

Section 2 of the new EFRAG guidance discusses six key components of the ESRS's approach to undertaking a double materiality assessment.

Section 2.1 - Implementing the concept of double materiality

Under the EFRAG guidance, both impact and financial materiality are defined as:

Impact materiality - is the consideration of any potential or actual impact on people or the environment. These impacts can be either positive or negative, over short, medium, or long-term, and can be connected to its own operations or within its value chain.

Financial materiality - is an assessment of whether topics trigger or could reasonably trigger a financial effect on the organisation. Financial effect meaning a potential risk or opportunity.

When deciding if a topic is material for CSRD, it is important to note that it can be either be an "impact" or "financially" material or both. It is important to note when undertaking the evaluation that impact and financial materiality are different but can overlap. It is therefore important to consider the synergies of the two in your approach and ensure evaluation takes place systematically. For example, organisations should first identify impacts related to the topics, then assess whether those impacts lead to risks or opportunities. Finally, businesses should seek to identify whether there are any risks or opportunities which are not linked to the impacts they have already explored.

Section 2.2 Sustainability matters for the materiality assessment

To provide a starting point, for each topic, the ESRS 1 General Requirements sets out a series of subtopics and corresponding sub-subtopics which must also be considered to ensure a comprehensive review and "level of granularity" in assessment. These are referred to as "Sustainability Matters".

For example, the topic of "Water and Marine Resources", has a subtopic of "Water" and within this subtopic, there are sub-subtopics of "Water Consumption", "Water Withdrawals" and "Water Discharges". A full list of Sustainability Matters is available in the Appendix of ESRS 1 under "AR16".

Some of the listed topics only have a few subtopics and corresponding sub-subtopics but others, such as the topic of "Works in the Value Chain" have 3 subtopics and within these, have 15 sub-subtopics to consider. This highlights the thoroughness required of a double materiality assessment – it is something which cannot be rushed and requires input from several stakeholders.

Each sub-subtopic has corresponding disclosure requirements and datapoints which must be reported on if the topic is found to be material. For example, under the topic of 'Own Workforce', there is the sub-subtopic of 'Health and Safety. If Health and Safety is identified as material then an organisation would be required to report against all the following disclosure requirements under ESRS S1 – Own Workforce: S1 - 1 – Policies, S1- 4 Taking Action, S1 – 5 – Targets, and S1 – 14 Health and Safety Metrics. This again highlights the level of detail which is expected in these assessments as well as the importance of ensuring that you get your double materiality process right.

Section 2.3 Criteria to determine the materiality of information

The following sections (2.3, 2.4 and 2.5) all relate to how information is reported, as opposed to defining the materiality of topics (sections 2.1 and 2.2).

As demonstrated by the example above, once a topic is identified as material there are several corresponding disclosure requirements. However, to ensure that reporting remains focused on only what is relevant, organisations should consider the "significance" of the information as well as the "decision-usefulness" to deem whether it should be included.

In practice making these considerations allows organisations to ensure that their reporting is as streamlined as possible whilst still disclosing the relevant detail needed on material issues. This section can be one of the hardest to grasp, as some have complained it feels contradictory to the steps in 2.2, which mandates which sustainability matters must be disclosed against.

Section 2.4 Scope of application of the materiality of information

Section 2.4 focuses on the flexibility businesses can have in filtering out the information they disclose based on the "significance" and "decision-usefulness" discussed in section 2.3. The most important thing to remember here, is that there are minimum disclosure requirements for policies, actions and targets. However, guidance suggests that when filtering out information it is more about deciding the level of detail of disclosures, rather than not including information. For example, in the case that an organisation does not have a policy, action or target this does not constitute a need to filter out the information. Instead stating that the organisation has not adopted such a policy should be disclosed and of itself a material piece of information.

The key here is to ensure that there is a balance. By disclosing too much detail, organisations risk overshadowing the material information, whereas disclosing not enough risks claims of greenwashing or being misleading.

Section 2.5 Datapoints derived from EU legislation

To help organisations with minimising the risk of duplication of disclosures, they have recognised the relevance of other standards and encourage signposting to related disclosures.

In the ESRS 2 guidance in Appendix B there are a list of data points called the 'Cross-Cutting and Topical Standards'. Organisations are required to include a table of all data points in Appendix B within their disclosure specifying either where they can be found in the reporting or for those which have been omitted because they are deemed not material, a statement to this fact. This supports organisations in streamlining reporting and avoiding duplication of disclosures.

Section 2.6 Consideration for upstream/downstream value chain

Perhaps one of the most fundamental elements of the ESRS approach is the need to consider the value chain and business relationships. Guidance explains that in order for the assessment to consider both the 'outside-in' and 'inside-out' impacts, risks and opportunities, then it must look to consult with those outside of the business. The section signposts to further guidance "EFRAG IG2 Value Chain Implementation Guidance".

Asesoria's Comment

Section 2 of the new guidance is arguably the best place to start in attempting to demystify double materiality because it focuses on ESRS's specific requirements for materiality including the application of double materiality, the purpose of the assessment as well as how to make disclosures. It is clear from the guidance that ESRS are aiming to set the direction of travel for materiality assessments. Although they align their approach with existing standards such as GRI, it is clear from the level in which double materiality is embedded within CSRD that they are trying to increase its importance to reporting. For example, by prescribing the disclosures and datapoints aligned to specific material topics, it ensures that organisations report transparently and comprehensively on these issues. It is clear that CSRD materiality is an important part of the process; it is evidently not just a tick box exercise but instead informs and underpins the full disclosure.

With double materiality being such a fundamental component of CSRD, it is surprising that despite numerous amends some have described the new guidance as "too confusing". It has been critiqued for providing vague guidance for some elements, yet incredibly specific instructions for others, as well as repetitive signposting to other guidance. This leads the reader to have to try and understand multiple documents simultaneously! The document even recognises its own complex nature, encouraging users to not substitute the guidance for the services of appropriate professionals.

However, when you are able to cut through this complexity and read between the lines, there are two core themes. Firstly, the importance of comprehensive, relevant and transparent reporting. We know that the EU is keen to crack down on greenwashing, particularly with the introduction of the Green Claims Directive, but when considering the importance of the materiality process for CSRD, it is clear this is at the core of the legislation. Secondly, it was evident to us that the identification of material topics was key – including within the businesses value chain. For us, this suggests that stakeholder engagement should largely underpin best practise materiality assessments. This means that the process is likely to be extensive, requiring a lot of resource and time. For our clients this has meant, starting in plenty of time, careful management and seeking external guidance and advice early to ensure that their double materiality assessment is detailed and comprehensive.

It has always been best practice to inform reporting with a materiality assessment to ensure that the organisation focuses on the most relevant areas. However, there is clearly a desire for organisations to conduct more thorough assessments of materiality and ensure that reporting is truly underpinned by it. With the introduction of the CSRD and accompanying standards, it is likely that businesses will need to take a new approach and perspective when it comes to materiality.

References and Footnote

You can read the new guidance here: EFRAG IG1 Materiality Assessment
More information on CSRD is available here: Greenwashing is Over!

Note 1 – Background to CSRD, ESRS and EFRAG

EFRAG is a private association, funded by the European Union (EU) to serve public interest in both financial and sustainability reporting. In 2020, the European Commission (EC) requested technical advice, requiring EFRAG to undertake work for a revised Non-Financial Reporting Directive (NFRD). In 2021, the EC adopted a legislative proposal for a Corporate Sustainability Reporting Directive (CSRD), which would require a significant number of companies (estimated around 50,000) with operations within the EU to report in line with the new European Sustainable Reporting Standards (ESRS). EFRAG have developed draft ESRS which underpin the reporting requirements for CSRD. In late 2022, the directive entered into force with companies in scope, to report on a rolling basis from 2024.