CSRD REPORTING SERIES

I.

DOUBLE MATERIALITY: WHAT YOU NEED TO KNOW

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Shift

DOUBLE MATERIALITY:

What you need to know

What you will learn:

In this first article in our CSRD mini-series, we explore **double materiality** and the assessment process for **impact materiality**, which mirrors the first step of due diligence under the international standards on responsible business conduct. This means that company resources spent on reporting are an investment in effective human rights due diligence – and vice versa.

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1. WHAT *IS* DOUBLE MATERIALITY?

The concept of materiality has been applied for many years in voluntary sustainability reporting standards, albeit with different meanings. For example, for the Global Reporting Initiative, the focus has been on the significance of impacts on people and planet; for the Sustainability Accounting Standards Board, it has been on implications for the financial success of the company.

"**Double materiality**," introduced for the first time in the European Sustainability Reporting Standards (ESRS), brings these two approaches together: ESRS 1 makes clear that it includes both impacts on people and the environment resulting from a company's activities and business relationships (impact materiality); and sustainability-related risks or opportunities that influence the company's "development, financial position, financial performance, cash flows, access to finance or cost of capital"[1] (financial materiality).[2] In sum, a sustainability matter is material "when it meets the criteria for impact materiality or financial materiality or both."

Impact materiality and financial materiality are considered "interrelated" by the ESRS: an impact on people or the environment can be financially material from the start, or become financially material over time. The evolving nature of this relationship is sometimes referred to as "**dynamic materiality**."[3]

2. WHAT DO THE ESRS TELL US ABOUT THE METHODS FOR ASSESSING MATERIALITY?

The key starting point is impact materiality.

First, the ESRS make clear that, "[i]n general, the starting point is the assessment of impacts, although there may also be material risks and opportunities that are not related to the undertaking's impacts."[4]

In other words, most financially material risks and opportunities with regard to sustainability will be a product of the company's material impacts on people and planet.

These assessments of materiality should therefore not be conducted as distinct and unrelated processes, but as sequenced and integrally related steps, beginning with impact materiality. This reflects our experience of best practice at Shift, where we've seen assumptions about how business risks arise lead companies' risk teams to consistently overlook significant risks that derive from impacts in their operations or value chains. The method outlined under the ESRS can help remove these blind spots.

At the same time, the ESRS recognize that there will be instances where systemic risks, such as climate change, biodiversity loss or inequality, also have a material effect on a company's financial success, even if its own operations and value chains have not significantly contributed to those phenomena. These too should be part of the materiality assessment.

Assessing material impacts mirrors the first step of human rights due diligence.

Second, in starting with the impact materiality process, the ESRS 1 anchors the assessment of negative impacts "in the sustainability due diligence process defined in the international instruments of the [UNGPs] and [OECD Guidelines]." It clarifies that materiality is based on the severity of the impact, considering (a) the scale of an impact – meaning how grave it is; (b) the scope of an impact – how widespread it is; and (c) the irremediable character of the impact – how hard it would be to put right. In this, the ESRS directly echo Principle 14 of the UNGPs.

ESRS 1 further clarifies that a sustainability matter can be material from an impact perspective whether it:

- is actual or potential; positive or negative;

- is caused, contributed to, or directly linked to the company's own operations, products or services through its business relationships, upstream and downstream, and not limited to direct contractual relationships;
- occurs over a short-, medium- or long-term time horizon.

The ESRS also note that companies can reference the various topic-specific standards as a kind of non-exhaustive check-list for identifying material matters. For social issues, this would mean considering impacts on the full range of potentially affected stakeholders: a company's own workforce, workers in its value chain, affected communities (round operations and in the value chain), and consumers and end-users.

In short, the impact materiality assessment mirrors the first step of due diligence under the international standards on responsible business conduct. **This means that those companies already conducting human rights due diligence in line with the UNGPs, will – in doing so – have identified the social impacts that would be material for their reporting under the ESRS.** For those not yet implementing the international standards, conducting the impact materiality assessment correctly will ensure they complete the first step in the due diligence journey.

Material impacts set the basis for the financial materiality assessment.

Third, this assessment of material impacts sets the foundation for companies to identify financially material matters. They need to consider how these material impacts may rebound in the form of material risks or opportunities for their financial position, performance, cash flows and access to finance. Companies should consider, not least, the potential for financial risks to arise where these impacts are a product of the company's business model.[5] Companies should also look at systemic issues that may raise material risks or opportunities, including the systemic risk of inequality.[6]

By setting the impact materiality assessment process as the starting point in the double materiality process, and aligning it with the first step of due diligence under the UNGPs and OECD Guidelines, the ESRS support a coherent and integrated relationship between impact materiality and financial materiality. They also ensure that the resources companies apply to the implementation of effective human rights due diligence are an investment in good reporting under the ESRS, and vice versa.

ENDNOTES

1 ESRS 1, 3.5

2 Impact materiality is sometimes referred to as 'inside-out' materiality, and financial materiality as 'outside-in' materiality

3 ESRS 1, 3.2

4 https://www.integratedreporting.org/resource/statement-of-intent-to-work-together-towards-comprehensive-corporate-reporting

5 ESRS 1, 3.3; see also ESRS 1, para 58, which states that, "The outcome of the undertaking's sustainability due diligence process (referred to as "due diligence" in the international instruments mentioned below) informs the undertaking's assessment of its material impacts, risks and opportunities."

6 ESRS 1, 3.2, para 27

7 https://shiftproject.org/resource/business-model-red-flags/red-flags-about/

8 https://tacklinginequality.org/flagship-report/

CSRD REPORTING SERIES: PART I

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ABOUT SHIFT

Shift is the leading center of expertise on the UN Guiding Principles on Business and Human Rights. Shift's global team of experts works across all continents and sectors to challenge assumptions, push boundaries, and redefine corporate practice, in order to build a world where business gets done with respect for people's dignity. Shift is a non-profit, mission-driven organization, headquartered in New York City. Visit **shiftproject.org** and follow us at @shiftproject.

CSRD MINI SERIES

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