

***[Draft] European Sustainability Reporting Guidelines 1
Double materiality conceptual guidelines
for standard-setting***

DISCLAIMER

This working paper is an Appendix to and must be read in conjunction with the related document '[PTF-ESRS Batch 1 working papers – Cover note and next steps](#)', which establishes the general context, the status of this working paper and the subsequent due process steps to be followed.

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WORKING PAPER

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[Draft] European Sustainability Reporting Guidelines 1

Double materiality conceptual guidelines for standard-setting

Introduction

- 1 The European Commission's proposal for the Corporate Sustainability Reporting Directive (CSRD) states in revised Article 19a of Directive 2013/34/EU that undertakings 'shall include in the management report information necessary to understand the undertaking's impacts on sustainability matters, and information necessary to understand how sustainability matters affect the undertaking's development, performance and position.' Recital 25 of (draft) CSRD elaborates on the double-materiality perspective that was introduced already in the Directive 2013/34/EU. Regarding both perspectives (impact materiality and financial materiality) the recital emphasises that 'undertakings should consider each materiality perspective in its own right, and should disclose information that is material from both perspectives as well as information that is material from only one perspective.'
- 2 As a consequence, information on sustainability matters which is material from one or both of these perspectives ('double materiality') should be included in the reports. Therefore, the European Sustainability Reporting Standards (ESRS) elaboration should assess which information meets the materiality criteria, and develop appropriate sector-agnostic and sector-specific disclosure requirements.
- 3 Recital 27 of the (draft) CSRD provides insight into which parameters should be taken into account in assessing impact materiality: 'an actual or potential adverse impact is to be considered principal where it measures among the greatest impacts connected with the undertaking's activities based on: the gravity of the impact on people or the environment; the number of individuals that are or could be affected, or the scale of damage to the environment; and the ease with which the harm could be remediated, restoring the environment or affected people to their prior state.'
- 4 The (draft) CSRD specifies that it should be made certain that the information reported by undertakings in accordance with ESRS meets users' needs.. Accordingly, the ESRS should specify the information that undertakings should disclose with regard to the principles and objectives of relevant EU policies, including the European Green Deal, the European Pillar of Social Rights, the Sustainable Finance Disclosure Regulation and the Taxonomy Regulation. Furthermore the standards should take into account internationally recognised principles and frameworks, including the UN Sustainable Development Goals, the UN Guiding Principles on Business and Human Rights, the OECD Guidelines for Multinational Enterprises, the OECD Due Diligence Guidance for Responsible Business Conduct and related sectoral guidelines, the UN Global Compact, the Tripartite Declaration of Principles of the International Labour Organisation concerning Multinational Enterprises and Social Policy, the ISO 26000 standard on social responsibility, and the UN Principles for Responsible Investment.
- 5 The above provisions and recitals of the (draft) CSRD are the main basis for these guidelines, whilst taking also into account the PTF-NFRS Report's recommendations. Guidelines on materiality assessment from the impact perspective have been informed inter alia by the GRI Universal Standards. Guidelines on materiality assessment from the financial perspective have been informed inter alia by the International Integrated Reporting Framework and concepts as discussed in particular in *How ESG Issues Become Financially Material to Corporations and Their Investors?* David Freiberg, Jean Rogers, George Serafeim – 2019/2020 Harvard Business School.

Objective

- 6 The purpose of these guidelines is to provide definitions, guidance, tools and processes that should be used by the [EFRAG Sustainability Standards Board (the 'Board')] to determine which sustainability topics or sub-topics are material, and therefore necessitate appropriate disclosures to be defined by the ESRS.

- 7 A similar task should be performed by the undertaking to determine (i) which additional information it should disclose, and (ii) whether the mandatory disclosures required by the reporting standards are all relevant for the undertaking, taking into account its specific circumstances and business context. In the second case, the undertaking should disclose the reasons that justify the absence of relevance of a specific mandatory disclosure and report a 'non-material disclosure'. The disclosure requirements and guidance for the entity-level materiality determination process are provided in the cross-cutting standard on risks, opportunities and impacts.

Scope

- 8 These guidelines provide in-depth definition of the double-materiality concept in order to facilitate its application.
- 9 These guidelines provide step-by-step guidance to be followed by [the Board] in assessing which sustainability topics or sub-topics are material for undertakings of all sectors and for undertakings from particular sectors.
- 10 These guidelines do not contain comprehensive instructions as to how [the Board] should design disclosure requirements. [The Board] should consult other guidelines, and take into account the specific nature of the identified material topics.
- 11 These guidelines do not provide disclosure requirements and guidance for the entity-level materiality determination, which should be performed by undertakings. These are provided in the cross-cutting standard on risks, opportunities and impacts.

Key concepts

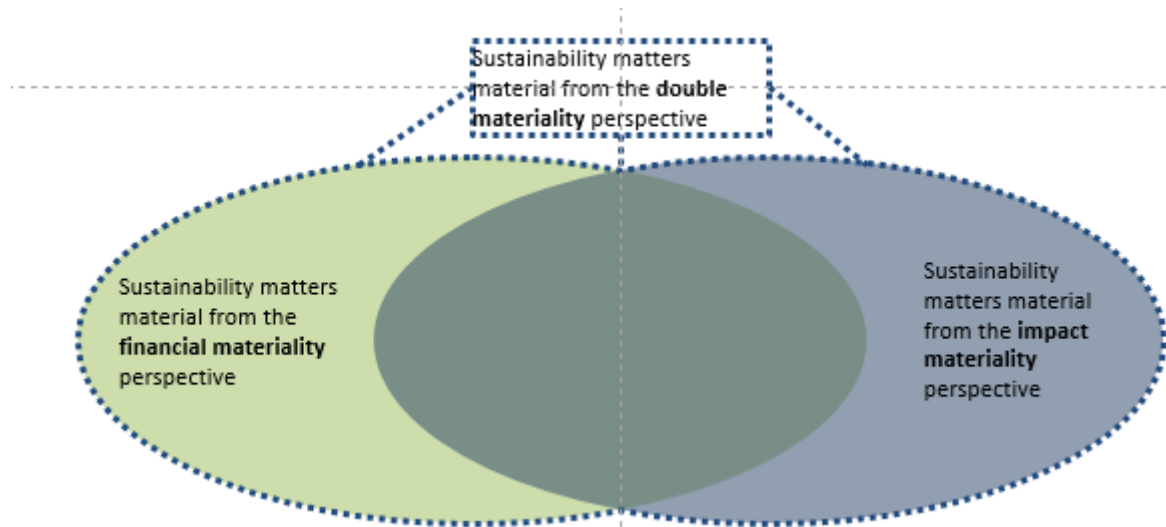
Materiality

- 12 Materiality is to be understood as the criterion for inclusion of specific information in corporate reports. It reflects (i) the significance of the information in relation to the phenomenon it purports to depict or explain, as well as (ii) its capacity to meet the needs and expectations of the stakeholders of an undertaking and of the undertaking itself, allowing for proper decision-making, and more generally (iii) the needs for transparency corresponding to the public interest.

Double materiality

- 13 Double materiality is a concept which provides criteria for determination of whether a sustainability topic or information has to be included in the undertaking's sustainability report. Double materiality is the union (in mathematical terms, i.e. union of two sets, not intersection) of impact materiality and financial materiality. A sustainability topic or information meets therefore the criteria of double materiality if it is material from the impact perspective or from the financial perspective or from both of these two perspectives.

Figure 1



Impact materiality

- 14 Impact materiality is a characteristic of a sustainability topic or information in relation to an undertaking, in a particular sector or in all sectors. A sustainability topic or information is material from an impact perspective if the undertaking is connected to actual or potential significant impacts on people or the environment and is related to the sustainability topic over the short, medium or long term. This includes impacts directly caused or contributed to by the undertaking and impacts which are otherwise directly linked to the undertaking's upstream and downstream value chain.
- 15 A negative impact is 'directly linked to' the undertaking's operations, products or services, if it occurs at any tier of business relationships, provided it occurs as part of the value chain. It is not restricted to most obvious links between the organisation and the other entity, and is therefore not limited for instance to direct contractual relationships, such as 'direct sourcing'. For example:
- (a) 'Direct linkage' does not refer to the distinction between direct and indirect impacts, as commonly used in differentiating various scopes of GHG emissions. Indirect GHG emissions, i.e. Scope 2 and Scope 3, are still 'directly linked' to the undertaking's operations, products and services. However, GHG emissions of a business partner that are not connected to the undertaking's value chain, are neither 'directly linked', nor are part of Scope 3 emissions.
 - (b) If the organisation uses cobalt in its products that is mined using child labour, the negative impact (i.e., child labour) is directly linked to the organisation's products through the tiers of business relationships in its supply chain (i.e., through the smelter and minerals trader, to the mining enterprise that uses child labour), even though the organisation has not caused or contributed to the negative impact itself.

Financial materiality

- 16 Financial materiality, as defined in the next paragraph, relates to financial materiality in sustainability reporting. The definition differs from the definition of materiality used in financial reporting. These guidelines do not relate to financial reporting by undertakings and therefore the definition of financial materiality below, used in sustainability reporting, should not be mistaken for the concept of materiality used in the process of determination which information should be included in the undertaking's financial statements.

- 17 Financial materiality in the context of sustainability reporting is a characteristic of a sustainability topic or information in relation to an undertaking, a particular sector or all sectors. A sustainability topic is material from a financial perspective if it triggers financial effects on undertakings, i.e. generates risks or opportunities that influence or are likely to influence the future cash flows and therefore the enterprise value of the undertaking in the short, medium or long term but are not captured by financial reporting at the reporting date. These risks and opportunities may derive from past events or future events and may have effects on future cash flows in relation (i) to assets and liabilities already recognised in financial reporting or that may be recognised as a result of future events or (ii) to factors of enterprise value creation that do not meet the accounting definition of assets (liabilities) and/or the related recognition criteria but contribute to the creation/maintenance of enterprise value. The latter are generally defined as « capitals » in frameworks promoting a multi-capital approach.
- 18 Triggers of financial effects may be attributed to two groups:
- (a) They may influence the undertaking's ability to continue to use or obtain the resources needed in its productive process;
 - (b) They may affect the undertaking's ability to rely on relationships needed in its productive processes in acceptable terms.

Sustainability matters and topics

- 19 A sustainability matter is a specific dimension of sustainability under which an undertaking has an impact on people or the environment or which results in risks or opportunities for the undertaking.
- 20 The terms 'topic' and 'sub-topic' are used with reference to a subject, a theme, a category or a general area of interest in the context of the specific topical standards to be drafted by [the Board]. Sustainability topics are structured groups of sustainability matters that on the highest structural level are grouped into environmental, social and governance topics, as defined in the (draft) CSR. The topical standards should further specify sustainability topics and sub-topics into concrete sustainability disclosure requirements.

Stakeholders

- 21 Stakeholders are those who can affect or be affected by the undertaking's decisions and actions.
- 22 Two main groups of stakeholders may be identified:
- (a) affected stakeholders – stakeholders who may be positively or negatively impacted by the undertaking's activities and through its value chain, and,
 - (b) users – stakeholders with an interest in the undertaking's sustainability reporting, including public authorities, business partners of the undertakings, equity investors (including asset managers) and lenders (including asset managers, credit institutions, insurance undertakings), civil society organisations, trade unions and social partners.
- 23 It is important to note that some, but not all, stakeholders may belong to both groups.

Parameters of adverse impact materiality

- 24 In case of adverse (negative) impact, parameters of impact materiality shall include:
- (a) the severity of actual negative impact, which is determined by scale, scope and irremediable character of the impact, and,
 - (b) the severity as well as likelihood of potential negative impact.
- 25 Scale of impact is the level of seriousness of negative impacts.

- 26 The scale of a negative impact can depend on whether the impact leads to non-compliance with laws and regulations or with authoritative intergovernmental instruments with which the organisation is expected to comply. For example, if a negative impact leads to a violation of human rights or fundamental rights at work, or to non-compliance with the reductions in greenhouse gas (GHG) emissions to be achieved under the United Nations (UN) Framework Convention on Climate Change (FCCC) Paris Agreement [4], the scale of this impact can be considered greater.
- 27 The scale of impact is a relative measure depending on the context in which the impact takes place. In the case of impacts on the environment, the condition and fragility of the impacted medium (such as water, soil, air, climate, and ecosystems) is an essential input to determine the seriousness of an impact. In case of impacts on people, the scale of an impact may depend on the extent to which the individuals affected are already in a situation of economic, social or other vulnerability. For example health impacts through pollution or chemicals use may be greater for individuals that already have compromised health or who lack access to healthcare; impacts on freedom of association may result in particularly grave impacts for individuals who are on low wages or in precarious forms of work.
- 28 Scope of impact is related to how widespread the impact is.
- 29 In case of environmental impacts the scope may be understood as the extent of environmental damage or a geographical perimeter. In case of impact on people the scope may be understood as the number of people adversely affected.
- 30 Remediability (irremediable character) concerns whether and to what extent the negative impacts could be remediated, restoring the environment or affected people to their prior state.
- 31 Any of the three characteristics (scale, scope, and irremediable character) can make an impact severe.

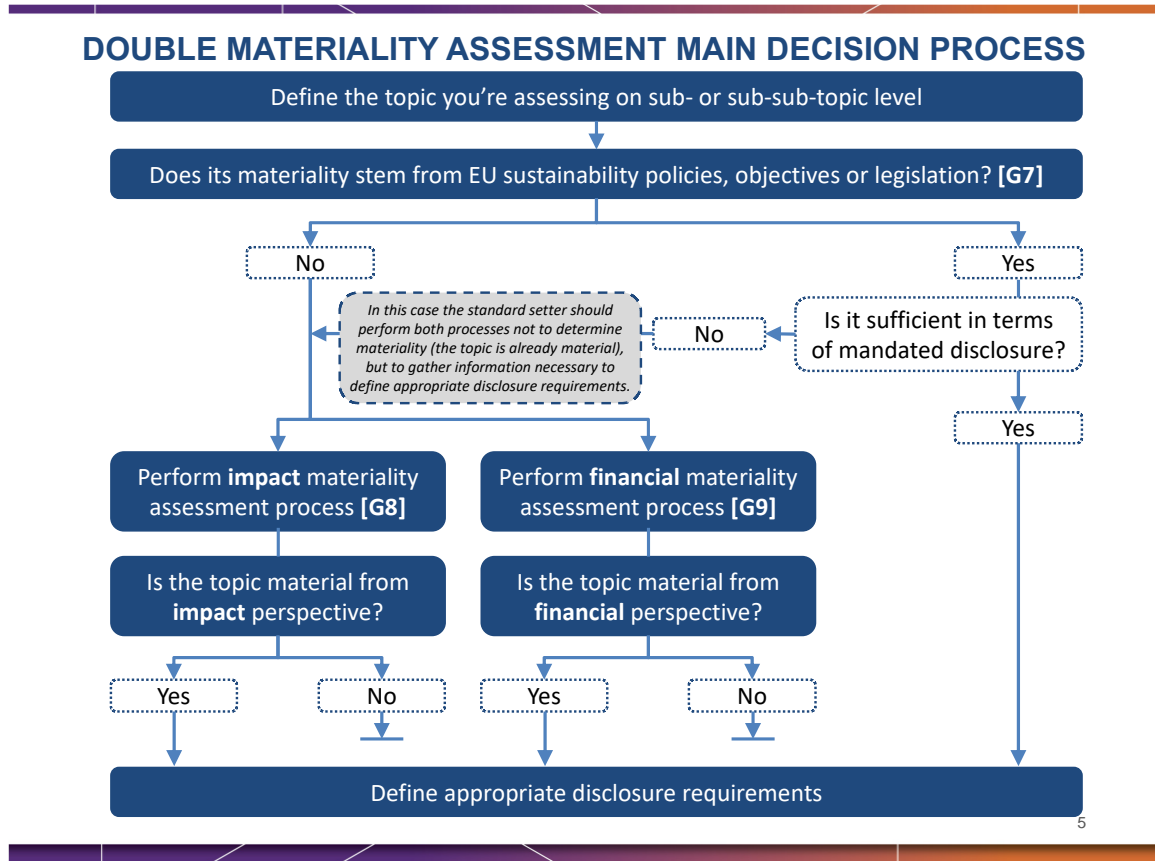
Guidelines

Guideline 1: Equal importance

- 32 In the materiality assessment process equal importance should be given to impact materiality and financial materiality.
- 33 [The Board] shall assess materiality of each sustainability topic from the impact perspective and from the financial perspective independently: a sustainability topic shall be deemed material if it is material from the impact perspective or from the financial perspective or from both perspectives.
- 34 Guideline 8 provides a process to assess materiality of a sustainability topic from the impact materiality perspective. Guideline 9 provides a process to assess materiality of a sustainability topic from the financial materiality perspective.
- 35 Impact materiality and financial materiality assessments are intertwined and interdependencies between the two dimensions should be considered in the assessments. In general, the starting point is assumed to be the impact materiality assessment, as a sustainability impact may become financially material when it translates for is likely to translate in the short-medium-long term into financial effects. However beyond the actual and potential financial consequences for the undertaking of its material impacts, the undertaking shall consider how it is affected by sustainability matters which are external to its activities.
- 36 The results of both materiality assessment processes should allow [the Board] to propose appropriate disclosures required in the reporting standards. Different disclosures may be required from undertakings in situations where the materiality topic is material from the impact perspective and/or where it is material from the financial materiality perspective. For example:

- (a) If the topic of GHG emissions is determined to be material from the impact perspective, [the Board] may design disclosure requirements to ensure transparency on the scale and scope of undertaking's impacts, such as for instance the requirement to disclose the amount of various scopes of GHG emitted. Since information on GHG emissions can also be material from the financial perspective, [the Board] may design additional disclosure requirements concerning the effect on the ability of the undertaking to create value, for example concerning the assessment of the influence of GHG emissions on the undertaking's future cash flows, such as the effect of carbon pricing mechanisms or of the participation in carbon allowances trading schemes.
 - (b) If the topic of workforce training in a particular area is considered material from the impact perspective, the standard setter may design disclosure requirements discussing development of skills and knowledge of employees who are responsible for the implementation of the undertaking's policy related to the identified negative impacts. If the topic of workforce training is material from the financial perspective, the standard setter may design disclosure requirements discussing the influence of training on the financial results of the undertaking (positive outcomes, costs of training etc.).
- 37 Materiality of a sustainability topic may result directly from EU sustainability policies, objectives or legislation. Determination whether this is the case is further discussed in Guideline 7. In this case two situations may occur:
- (a) Materiality of a sustainability topic results from EU sustainability policies, objectives or legislation which also provide for adequate details as to the disclosures required from the undertakings. In this situation the ESS is not expected to further assess materiality of this topic from the impact perspective and from the financial perspective.
 - (b) Materiality of a sustainability topic results from EU sustainability policies, objectives or legislation which do not provide details as to the disclosures required from the undertakings. In this situation [the Board] should proceed with materiality assessment processes from the impact perspective and from the financial perspective (using Guidelines 8 and 9). These processes should not result in the standard setter's changing their decision as to the materiality of the sustainability topic, but their results should be used to inform the design of disclosure requirements.
- 38 The main decision process in materiality assessment to be performed by the standard setter, as defined in the above Guideline 1, may be depicted as per Figure 2 below.

Figure 2



Guideline 2: Identification of sustainability topics

- 39 [The Board] should identify sustainability topics and structure them before performing the materiality assessment.
- 40 The basis for the identification and categorisation of sustainability topics is provided by the CSRD. In order to perform the materiality assessment and develop the disclosure requirements, a higher granularity than what is provided by the Directive may be needed.
- 41 The categorisation levels of sustainability topics should include:
- (a) Level 1: TOPICS (Environment, Social, Governance)
 - (b) Level 2: SUB-TOPICS (for example: climate change mitigation)
 - (c) Level 3: SUB-SUB-TOPICS (for example: energy consumption)
 - (d) Below level 3 (optionally): disclosure (requirements)
- 42 [The Board] should take into consideration the following input when defining sustainability topics (or sub-topics or sub-sub-topics):
- (a) Research into the current use of sustainability indicators/disclosures in widely applied reporting standards, and lessons gained from their application in practice.
 - (b) Multi-stakeholder consultation that includes individuals with subject matter expertise across the full range of sustainability matters and both impact materiality and financial materiality perspectives, including the primary users in accordance with Guideline 3.
 - (c) Identification of particular risks, opportunities and impacts resulting from or for a sustainability topic at a chosen level of granularity.

Guideline 3: Affected stakeholders and users

- 43 For each identified sustainability topic, [the Board] should identify the relevant stakeholders and users and their information needs, as the basis for the process of deciding on the materiality of the topic and the development of related disclosure requirements.
- 44 The materiality assessment process should ensure that impact on all affected stakeholders is taken into account and not only the needs of users.
- 45 Affected stakeholders: The materiality of impacts on affected stakeholders should be assessed based on the actual or potential harm or benefits to the potentially impacted people and their rights, damage or benefits to the environment and related public interests outlined in EU policies. The material information in this regard includes information on adverse actual or potential impacts, the involvement of the undertaking with the impact, the undertaking's policy and objectives, actions, and the effectiveness of those actions in terms of preventing or mitigating the impacts and maximising positive outcomes for people or the environment.
- 46 User stakeholders: The users of sustainability information disclosed in corporate annual reports can be divided into two groups, whose needs may differ: on the one hand, equity investors, credit institutions (banks), insurance undertakings (insurers); and on the other hand, public authorities, business partners, non-governmental organisations, social partners and other stakeholders (including end-users of products and services). The above distinction is a helpful tool but [the Board] should also take into account the many intersections or interrelations that may exist between these different groups.
- 47 Equity investors, including asset managers, as well as banks and insurers want to better understand the risks of, and opportunities afforded by, sustainability matters in relation to their own activities (investment, financing, trading, insurance...) including the long-term horizon, as well as the impacts of those activities on people and the environment. When assessing which information is material, [the Board] should also consider which information this group of stakeholders needs in order to be able to meet their own sustainability goals and their disclosure obligations based on the EU policies, including any systemic risks to the stability of the financial system.
- 48 Non-governmental organisations, social partners and other stakeholders want to hold undertakings to greater account for the impacts of their activities on people and the environment. Public authorities need sustainability information to assess the progress of the business sector towards relevant public objectives, as well as in the context of public procurement. Business partners, in particular buyers, need information on the undertaking's sustainability performance that is relevant for their own sustainability-related goals, objectives and targets. In addition to information on specific instances of adverse impacts on people and environment, serving these users' needs requires (i) disclosure of information that enables the assessment of the likelihood that the undertaking is or could be connected to such impacts, and whether and how it is taking action to reduce that possibility. This shall include information on the undertaking's value chain and on potentially affected stakeholders (including workers in the value chain and communities), and (ii) disclosure of the information on the integration of sustainability strategies and due diligence in its governance and business practices. Social partners need sustainability information which enables a better understanding of, and an appropriate decision making about the contribution to, and the sustainable development of the undertaking. End users of products and services increasingly need sustainability information from the business sector in order to guide their decisions in relation to sustainable consumption and development, they are the stakeholders that may trigger, together with the associated NGOs, reputational damage or benefit for undertakings.

Guideline 4: Value chain and time horizons

- 49 Materiality of a sustainability topic should be assessed over the whole value chain and over all time horizons.
- 50 [The Board] should use [ESRG 4 *Levels of reporting and boundaries*] to determine the boundaries of the materiality assessment regarding a sustainability topic.
- 51 [The Board] should use [ESRG 3 *Time horizon*] to identify short, medium and long term horizons in which materiality of sustainability topics should be assessed.

Guideline 5: Differentiation between sector-agnostic, sector-specific and entity-specific disclosures

- 52 Specificity of sectors should be taken into account by [the Board] when assessing the materiality of the sustainability topics and related disclosures.
- 53 [The Board] should determine which sustainability topics are:
- (a) material to all undertakings regardless of their sector, and therefore to be considered for appropriate disclosure requirements for all undertakings (i.e. sector-agnostic level),
 - (b) material to most undertakings within specific sectors and therefore to be considered for appropriate disclosure requirements for undertakings belonging to each specific sector (i.e. sector-specific level), and
 - (c) likely to be material for some or even a significant number of undertakings within a specific sector or across sectors, but where [the Board] considers that the disclosure requirements should be subject to the reporting undertaking's own assessment of materiality based on the undertaking's specific circumstances (i.e. entity-level).
- 54 As a general rule, materiality of a sustainability topic should be assessed in relation to all undertakings, i.e. under a sector-agnostic perspective: in cases where a sustainability topic is likely to be material for all or a large majority of undertakings in all sectors, [the Board] should identify disclosures regarding this sustainability topic, that are material and thus appropriate to be considered as mandatory for all undertakings.
- 55 If a sustainability topic is not material for all undertakings regardless of their sector, [the Board] should specify for which sectors it is material.
- 56 [The Board] should identify disclosures that are material to undertakings within specific sectors (sector-specific disclosure requirements) and disclosures that may be material for some or even a significant number of undertakings, but should be subject to the undertakings' own materiality determination.
- 57 In particular, the following factors should be taken into account by [the Board] when assessing which sustainability topics are material for undertakings in a particular sector:
- (a) existing EU sector legal requirements and sector-specific sustainability goals, as well as international agreements and standards concerning sustainability matters and/or corporate responsibility endorsed by the EU, as further explained in Guideline 7.
 - (b) the extent to which the most severe impacts and risks linked to sustainability topics would not be covered, or not covered enough, by sector-agnostic sustainability reporting.
 - (c) the existence of widely accepted sector-specific good practice in each sustainability topic, including sector-specific science-based targets, where relevant, applicable and available.
 - (d) research into the current use of sustainability indicators/disclosures in widely-applied reporting standards, and lessons gained from their application in practice, including identified gaps.
 - (e) the extent to which these are likely to be material for all or a large majority of undertakings in a sector.
- 58 In so far as the impact perspective is concerned, the above assessments of cross-sectoral (i.e. sector-agnostic) and sectoral (i.e. sector-specific) materiality by [the Board] should not be subject to thresholds concerning the level of an average individual undertaking's contribution to the impact, or its level of control or influence over such impact (e.g. the fact that individual undertaking's contribution to climate change is very small or that severe human rights impacts, such as forced labour for instance, occur several tiers away in the undertaking's value chain, does not render such impacts a non-material issue neither at the undertaking level, nor for the purpose of developing sector-agnostic or sector-specific disclosure requirements).
- 59 In cases where [the Board] determines that the materiality depends on the individual undertaking's business context, including its exposure to the impacts or risks, the particular characteristics of its value chain, or the location of its operations, [the Board] should develop criteria including risk factors ('red flags') for the undertaking to follow in its own materiality decision process, and for the justification of why it decides to disclose or not such specific information.

Guideline 6: Materiality of non-mature topics

- 60 In some situations, a particular sustainability topic may be assessed by [the Board] as material, but it is not possible to determine specific disclosure requirements that would ensure relevant and reliable information on outcomes of undertakings' policies relating to that matter. In this case, [the Board] should distinguish between, on the one hand, the determination of sustainability matters as material, based on principles underpinning the two perspectives of double materiality, and, on the other hand, the viability of mandating specific disclosures in relation to those material matters.
- 61 [The Board] should rigorously assess whether the disclosure requirements, in particular those that address outcome indicators, meet the general and specific criteria for quality of information, taking into account:
- (a) the experience of reporting on the topic (research into the current use of sustainability indicators/disclosures in widely applied reporting standards, and lessons gained from their application in practice, including identified gaps);
 - (b) lessons drawn from the effects of application of relevant outcome indicators, in particular any unintended consequences in practices or interpretation of the information;
 - (c) information value of standardised disclosures to primary users of the information, considering the need for context-specific information.
- 62 For the sustainability matters for which [the Board] will not identify relevant outcome indicators meeting the necessary quality criteria, [the Board] should:
- (a) develop topical guidance to undertakings on how to determine their own entity-specific outcome criteria;
 - (b) provide disclosure requirements and indicators that allow the undertaking to assess its exposure to the impacts and risks relevant to the topic. Such indicators should help undertakings and users of the information to determine the need for the entity-specific disclosures.

Guideline 7: Materiality stemming from EU sustainability policies, objectives and legislation

- 63 [The Board's] materiality assessment process should consider reporting obligations stemming from ESG/sustainability policy initiatives at EU level as well as at international level (to the extent they are recognised at EU level). This approach takes precedence over the assessment of materiality from the impact perspective and from the financial perspective, as indicated under Guideline 1 and further developed under guidelines 8 and 9.
- 64 All sustainability matters, topics and subtopics outlined in the CSRD should be presumed by the ESS as likely to be material for all companies (i.e. sector-agnostic) and then to be assessed by the ESS and the undertaking under their own materiality assessment processes. [The Board] should specify related disclosure requirements applicable at sector-agnostic and sector-specific level, or that are subject to materiality determination by the undertakings.
- 65 [The Board] should in particular ensure coherence and complementarity of the ESRS with the disclosure requirements pursuant to the Sustainable Finance Disclosure Regulation by designating as material the information needed by financial market participants in order to meet their own disclosure obligations.
- 66 [The Board] should analyse the content of the EU legislation, public policies and international agreements, standards and commitments endorsed by the EU related to each sub-topic covered by the scope of the CSRD, in order to identify relevant EU public policy features, related goals and, where available, more detailed sustainability criteria, and define corresponding reporting objectives.
- 67 For each such reporting objective, [the Board] should define disclosure requirements that allow an appropriate understanding of the undertaking's contribution to those public policy features and collective progress towards full alignment with the EU goals and criteria.
- 68 The reporting obligations should reflect the time horizons of the public goals, such as for example, in the assessment of the contribution to climate change adaptation and mitigation, in alignment with the latest climate science recommended by the IPCC / the Paris Climate Agreement and EU climate targets for 2030 and 2050.

- 69 Furthermore, for relevant public policies, [the Board] should determine the existence of systemic or structural risks regarding impacts on people and environment, as well as for the undertakings themselves, and define indicators that allow an appropriate understanding of likelihood that the undertaking could be connected to such risks, such as information on company's value chain, use of high-risk commodities, the extent of contingent labour in the workforce, the extent of freedom of association and collective bargaining.
- 70 [The Board] should consider the EU policies and legislations underpinning the identified disclosure requirements in determination whether the identified disclosure requirements are sector-agnostic (i.e. mandatory for all companies) or sector-specific (i.e. mandatory for companies within a specific sector) or subject to the undertaking's own materiality assessment (i.e. entity-specific).

Guideline 8: Impact materiality assessment process to be performed by [the Board]

- 71 Please note that in each case the word 'sustainability topic' is used, it stands for 'sub-topic' or for 'sub-sub-topic'.
- 72 This guideline lays out a process to be performed by [the Board] to assess the materiality of a sustainability topic from the impact perspective. The assessment of the materiality of sustainability topics and related disclosures must be informed at every step by an engagement with subject-matter experts in relevant areas. Furthermore, when the materiality of a sustainability topic from the impact perspective is widely recognised by relevant experts, frameworks or organisations, these impacts can be considered as material by the ESS as based upon consensus without performing all steps described below. This particularly applies in the context of standards that mandate disclosures building on and consolidating existing disclosure standards and frameworks and best practices (as is the case in particular for the first sets of standards). Beyond those circumstances, the process includes an assessment mechanism, presented below on a step-by-step basis, that aims at (i) providing a common framework for the analysis performed by [the Board] in the course of determination of materiality, (ii) achieving a certain degree of objectivity and comparability as to the analysis performed by [the Board] to assess materiality and (iii) serving as a tool organising the assessment process. Any results obtained through the use of the assessment mechanism must be informed by and balanced with expert judgement and necessary adjustments are often needed as a result of this balancing exercise before finalisation of the assessment.
- 73 [The Board] should assess each parameter (scale, scope and remediability) of impact materiality individually, as well as in combination with all other parameters. Any of the parameters of impact materiality can make an impact severe, resulting in the topic being assessed as material at the appropriate level (sector-agnostic, sector-specific, or subject to undertaking's own materiality assessment).
- 74 Any assessment of the scale of specific aspects of impact materiality should be understood as an input into the overall assessment process. The application and interpretation of such partial assessments should be subject to the judgement of [the Board]. [The Board] should perform the impact materiality assessment process in relation to every sustainability topic. As a result, [the Board] should define which sustainability topics are material from an impact perspective for all undertakings, which ones are material only for undertakings in particular sectors and which ones should be based on the undertaking's own assessment of their materiality.
- 75 The materiality of each topic should be assessed on a stand-alone basis, rather than in comparison to other topics.
- 76 The assessment of relevance of the ultimate disclosure requirements should be performed in cases where it (be they sector-agnostic, sector-specific or entity-specific) is not automatically derived from the materiality of the subtopic they cover; that is where the disclosure requirements do not directly describe the underlying risk, opportunity or impact, or the outcome of their management. Disclosure requirements should always be assessed against the criteria for quality of information provided in the relevant Conceptual Guidelines.
- 77 The following steps should be followed for the assessment:

Step 1: Specify the definition of the assessed sustainability topic.

78 Define the sustainability topic that is subject to impact materiality assessment. This includes decision on granularity of the analysis and on the distinction between the topic assessed and other topics that may be related to it but should be assessed independently. In general, the assessment should be performed at the sub-topic or sub-sub-topic level. In most cases, a more granular analysis allows for a more precise result of the assessment. The most granular level at which assessment is performed should be the level at which impacts can still be determined.

Step 2: Assess parameters of impact materiality of the sustainability topic.

79 Based on the definitions of the impact materiality parameters and using guidelines 3, 4 and 5, conduct an analysis of parameters of impact materiality of the sustainability topic in relation to all undertakings taken as a whole or to specific sectors. The results of the analysis will feed into step 3.

80 Analysis of parameters of impact materiality should be performed taking into account the current state of research into the topic and the most up-to-date information accessible for the standard setter, in consultation with recognised subject-matter experts, organisations or institutions in relation to the analysed topic, which may provide the standard setter with adequate insight into the impacts regarding the topic.

81 The purpose of this assessment is to consider whether the impacts are relevant to a significant number of undertakings such that they justify imposition of disclosure requirements at sector-agnostic or sector-specific level.

Step 2A: Determine the scale of impact

82 Scale of impact should be measured on the following intensity scale:

Scale of impact	
5	absolute
4	high
3	medium
2	low
1	minimal
0	none

Step 2B: Determine the scope of impact

83 Scope of impact should be measured on the following scale:

Scope of impact	
5	global/total
4	widespread
3	medium
2	concentrated
1	limited
0	none

Step 2C: Determine the remediability of impact

84 Remediability should be measured on the following scale:

Remediability of impact	
5	non-remediable/irreversible
4	very difficult to remedy or long-term
3	difficult to remedy or mid-term

2	remediable with effort (time & cost)
1	relatively easy to remedy short-term
0	very easy to remedy

Additional note regarding Steps 2A-2C

85 The above scales are continuous and limited by the maximum and minimum scores presented in the tables. It is possible to use scores that are in-between of the indicative scores presented in the tables. For example a scope of impact judged as ‘very widespread’, but not ‘global/total’ may be attributed a score of 4.5 (between 4 – widespread and 5 – global/total).

Step 3: Determine the preliminary impact materiality of the analysed topic

86 Use the results of Step 2 to determine the overall score, which will serve as a proxy indicator of preliminary overall impact materiality, using the following formula:

$$\text{Preliminary Impact Materiality} = \text{Scale of Impact} + \text{Scope of Impact} + \text{Remediability}$$

87 If scale of impact is assessed in step 2A as absolute and/or scope of impact is assessed in step 2B as global/total and/or remediability of impact is assessed in step 2C as non-remediable/irreversible, override results of the formula and set the level of preliminary impact materiality of this sustainability topic as critical.

88 Preliminary impact materiality should be described using the following table:

Preliminary impact materiality	
≥ 12	critical
[10,12)	significant
[8,10)	important
[5,8)	informative
< 5	minimal

Step 4

89 Perform a judgement on results of steps 2 and 3 to determine whether the materiality of the analysed topic can be established in this way.

90 The above judgement should include consideration of the current state as well as of the projected development of the likelihood of the materialisation of the underlying impacts at sector-agnostic and sector-specific levels, in all time horizons relevant to the impact. Likelihood is an important parameter in exercising judgement when assessing potential impacts and should be assessed in cases where [the Board] assesses that severity (i.e. scale, scope, remediability) of a particular impact may change in the future.

91 If in [the Board’s] judgement it is not clear whether the proxy indicator provides a sufficient basis for appropriate determination of the level of materiality of the analysed topic, [the Board] should seek further input from subject-matter experts to reach its final conclusion.

92 The ESS should then express the materiality of the analysed topic, whether determined on the basis of the proxy indicator or adjusted on the basis of further expert input, using the same names of levels, as the ones used in step 3 (critical, significant, important, informative, minimal).

93 Although the process for materiality assessment from the impact perspective is designed primarily for identification and assessment of negative impacts the undertakings have or may have on sustainability topics, [the Board] should also consider positive impacts. Positive impacts are also subject to the undertaking’s entity-specific materiality assessment, the reporting on which is addressed in the [ESRS 4 Sustainability material impacts, risks and opportunities].

94 If the result is critical, significant or important, end the process on Step 4 and deem the sustainability topic as material for all undertakings from the impact perspective. If the result is informative or minimal, perform Step 5.

95 If the result is critical, significant or important, but in the course of the assessment [the Board] noticed potential significant differences of the level of materiality of the analysed topic across sectors, [the Board] should proceed to perform Step 5. In this case the results of Step 5 should be used by [the Board] to differentiate the appropriate disclosure requirements for different sectors with regard to this topic.

Step 5 (conditional)

96 This step is to be performed only in cases where Step 4 resulted with the sustainability topic being assessed as informative, or minimal.

97 Perform Steps 2, 3 and 4 for the sustainability topic in relation to every sector separately. The result of these assessments allows [the Board] to determine for which particular sectors the sustainability topic is material and for which sectors it is not material from the impact perspective. Results of Step 5 should be used to determine appropriate sector-specific disclosures.

98 Final results of the impact materiality assessment process can be presented with sectoral granularity in a table following the below template:

Impact materiality of topic per sector	Sector 1	Sector 2	Sector 3	Sector 4	Sector 5
Topic 1	significant	significant	important	important	critical
Topic 2	critical (all undertakings)				
Topic 3	minimal	minimal	significant	informative	minimal
Topic 4	significant (all undertakings)				

Guideline 9: Financial materiality assessment process to be performed by [the Board]

99 Please note that in each case the word ‘sustainability topic’ is used, it stands for ‘sub-topic’ or for ‘sub-sub-topic’.

100 This guideline lays out a process to be performed by [the Board] to assess the materiality of a sustainability topic from the financial perspective. The process includes an assessment mechanism that aims at achieving a certain degree of objectivity and comparability. Any results obtained through the use of the assessment mechanism must be balanced with expert judgement and necessary adjustments are often needed as a result of this balancing exercise before finalisation of the assessment.

101 [The Board] should perform the same financial materiality assessment process in relation to every sustainability topic, applying the following steps. As a result, [the Board] should define which sustainability topics are material from a financial perspective for all undertakings and which ones are material for undertakings in particular sectors. Additionally, [the Board] should perform a mapping exercise that should help to design appropriate disclosure requirements resulting from the financial materiality assessment process.

102 Steps 1-3 defined below should be taken in relation to a particular sustainability topic. The procedure should be repeated for every sustainability topic that is in scope of the standard setter’s mandate. Step 4 is conditional and should be performed only in relation to sustainability topics assessed as material as a result of Step 3.

103 Assessment should be performed first in relation to all undertakings, i.e., at sector-agnostic level. If this assessment results in the sustainability topic being non-material, the assessment should be repeated in relation to particular sectors in order to assess for which sectors this sustainability topic is material and for which sectors it is non-material.

104 The following steps should be followed for the assessment:

Step 1: Specify definition of the assessed sustainability topic.

105 Define the sustainability topic that is subject to financial materiality assessment. This includes decision on granularity of the analysis and on the distinction between the topic assessed and other topics that may be related to it but should be assessed independently. In general, assessment should be performed at the sub-topic or sub-sub-topic level. In most cases, a more granular analysis allows for a more precise results of the assessment. The most granular level at which assessment is performed should be the level at which financial effects can still be determined.

Step 2: Assess triggers of financial effects and identify material financial effects

106 The purpose of this step is to identify the positive and/or negative likely effects (i.e. risks and opportunities that are financially material) of the sustainability topic defined following Step 1 that influence or are likely to influence the enterprise value of the undertaking in the short, medium or long term but are not captured by financial reporting.

107 The identification of these effects should be done by assessing the triggers of financial value creation. Such triggers are generally attributed from a conceptual standpoint to two groups: (i) continuation of use of, or access to, resources by the undertaking and/or (ii) reliance of the undertaking on relationships.

108 For completeness reasons, the identification and assessment of the potential triggers of financial effects should be done conventionally assuming as a starting point the ‘capitals’ that are used by the undertaking, ‘capitals’ which are not systematically recognised in financial statements as a consequence of the financial reporting conceptual framework. These capitals are multifaceted, for instance, following an IIRC-type classification: financial, manufacturing, natural, intellectual, human, social and relationship capitals. Such a classification captures the key factors of value creation and can be used as a reference to perform the financial materiality analysis.

109 The assessment of triggers of financial effects should be done at sector-agnostic level, i.e. for all undertakings. Some of the triggers of financial effects may be immaterial for some undertakings (for example for undertakings in some sectors), but they may be material from a broader perspective, taking into account cross-sectoral relations, particularly in developed value chains.

Step 2A: Continuation of use of resources

110 To assess whether the undertakings will be able to continue to use the resources (including workforce) needed in their business process, [the Board] should consider *inter alia* the following aspects:

- (a) Pricing and margins.
- (b) The market for the resource and the available supply.
- (c) The degradation and remaining useful life of the resource, the ability and the cost of maintaining or recreating.
- (d) Policy/regulatory constraints.

Continuation of use of resources		Tick all ‘capitals’ this trigger relates to:					
		financial	manufacturing	natural	intellectual	human	social and relationship
4	impossible, very costly or unavailable in the short term						
3	possible but costly in the short term, very costly or lacking in the medium term, impossible in the long term						

2	possible in the short term, costly in the medium term, very costly in the long term						
1	possible in the short, medium and long term						
0	without consequence in the short, medium and long term						

Step 2B: Reliance on relationships

111 To assess whether the undertakings will be able to continue to rely on the relationships needed in their production process on the same terms as the ones currently prevailing or whether the undertakings' practices will trigger an adverse reaction, [the Board] should consider *inter alia* the following aspects:

- (a) Financial institutions and providers of financial capital.
- (b) Supply chain, including contractors.
- (c) Customers (competitive/ethical behaviour, privacy, satisfaction, product impact on health, marketing and communication, product safety), including brand and reputational consequences.
- (d) External stakeholders.
- (e) Broader society/communities, including tolerability of the negative externalities produced by the undertakings.

Reliance on relationships		Check all 'capitals' this trigger relates to:					
		financial	manufacturing	natural	intellectual	human	social and relationship
4	strong adverse reaction currently or very likely in the future						
3	adverse reaction currently, strong adverse reaction likely in the future						
2	negative reaction currently, adverse reaction likely in the future						
1	signs of negative reaction currently or in the future						
0	neutral / no reaction currently and likely in the future						

Additional note regarding Steps 2A-2B:

112 The above scales are continuous and limited by the maximum and minimum scores presented in the tables. It is possible to use scores that are in-between of the indicative scores presented in the tables.

Step 3: Determine financial materiality of a sustainability topic

113 The purpose of this step is to finalise the materiality assessment for the defined sustainability topic. Financial materiality of the financial effect is determined by the highest of the two scores under Step 2.

114 Financial materiality should be described using the following results table:

Financial materiality	
4	critical
3	significant
2	important
1	informative
0	minimal

115 If the result is *critical*, *significant* or *important*, the financial effect should be assessed as material from the financial perspective and [the Board] should proceed to Step 4. If the result is *informative* or *minimal*, the topic should be assessed as non-material from the financial perspective and the assessment process is finished.

Step 4 (conditional): Mapping of possible disclosure areas for each material financial effect to facilitate design of disclosure requirements.

116 The purpose of this step is to identify one or several disclosure areas [the Board] should consider when designing the disclosure requirement(s) that correspond to the financial effect considered material following Step 3. This identification should be made under a classification of disclosure areas which is designed to complement and, when appropriate, to connect to financial reporting. As a consequence sustainability disclosures should provide relevant information on financially material aspects of the defined topic which are not or not yet reflected in financial reporting as prepared in accordance with accounting standards and with their underlying conceptual framework.

117 [The Board] shall therefore identify positive or negative likely effects of a sustainability topic on future cash flows related to (i) assets and liabilities that are or can be recognised in financial reporting but for which financial reporting should be complemented and (ii) on the capitals that are not and cannot be recognised in financial statements but have an influence on the performance and value creation of the undertakings. The identification includes both consequences from past events and consequences from future events.

118 [The Board] shall verify and localise potential effects generated by the triggers in one or more sustainability disclosure areas. The four sustainability disclosure areas to be considered in this step are:

119 Sustainability disclosure area 1: Positive or negative likely impacts on future cash flows of assets and liabilities that are recognised or can be recognised, resulting from past events but with effect on future cash flows that are not (or not yet) reported in financial statements (primary statements or notes), including the 'more likely than not' criterion below.

120 Two situations may appear in sustainability disclosure area 1:

- (a) Situations more likely than not: This should cover situations of likely decrease (or increase) of cash flow generation from assets or liabilities that are not already considered for accounting purposes as generating a negative (or positive) net cash flow in future periods.
- (b) Situations not more likely than not: This should cover situations where the likelihood is below the 'more likely than not' criterion (even if judgmental) but still significant and where disclosures should go one step further to what is reported in financial statements, by covering less likely (not more likely than not) scenarios related to assets/liabilities that are not (yet) recognised.

- 121 Sustainability disclosure area 2: Possible financial risks or opportunities affecting recognised assets or liabilities (i.e., positive or negative likely effects on future cash flows) that may result from future events; their effect on future cash flows is not yet recognised (as not deriving from past events).
- 122 Sustainability disclosure area 3: Disclosure on the currently used ‘capitals’ that contribute to the creation/maintenance of the enterprise value. They do not meet the accounting definition of assets (liabilities) and/or the recognition criteria but are related to past events.
- 123 Sustainability disclosure area 4: Disclosure on the future expected developments (related to future events) to the used ‘capitals’ that contribute to the creation/maintenance of enterprise value.
- 124 Localisation of financial effects should be done by filling-in the following table. An ‘X’ sign shall be marked in each cell where a particular financial effect relates to a particular area of sustainability disclosure:

	Sustainability disclosure area 1 (recognised assets and/or liabilities; past events)		Sustainability disclosure area 2 (recognised assets and/or liabilities; future events)	Sustainability disclosure area 3 (unrecognised assets; past events)	Sustainability disclosure area 4 (unrecognised assets; future events)
	Situations more likely than not	Situations not more likely than not			
Identified material effect					

- 125 [The Board] shall use results of the mapping exercise as a support to design appropriate disclosure requirements for the topic assessed as material from the financial perspective. Connectivity to financial statements and relating to ‘capitals’ should be considered where appropriate.

Appendix: Background research - Approach to financial materiality

- 1 This paper is a contribution of two EFRAG Task-Force participants performed in August 2021. It does not reflect the official positions of EFRAG and is attached as background research.

Objective

- 2 The purpose of this Appendix is to approach financial materiality for sustainability reporting, starting from the disclosures that derive from financial reporting and enterprise value creation and then defining sustainability financial related disclosures as the ones encompassing financial related sustainability information that are not captured, or not captured yet, by financial reporting. The underlying objective is to foster a seamless and more comprehensive financial related corporate reporting, combining financial reporting per se and financial related sustainability reporting.
- 3 This Appendix presents the approach to financial materiality to be used in sustainability standard setting; the intended user of this Appendix is the standard setter and not the reporting entity. This Appendix supports the identification of what the standard setter should require to be reported, i.e. to be mandatorily included in the report.
- 4 The process for assessing by the reporting entity which material risks and opportunities will have to be included in the report will be covered by the cross-cutting standard ESRS 4 *Sustainability material impacts, risks and opportunities*. This Appendix may also (indirectly) assist the reporting entity in providing a contextual background to the exercise of judgement requested when running its own materiality assessment. This is a secondary purpose of this Appendix.

Background

- 5 With a double materiality perspective, when looking at the financial materiality, the sustainability standard setter shall identify the possible ESG risks and opportunities (in neutral terms: factors) that are financially material, i.e. may positively or negatively affect the reporting entity's development, performance and position (over the short, medium or long term) and, therefore, create or erode its enterprise value.
- 6 In addition, the CSRD proposal puts an emphasis on intangible elements: Undertakings shall also disclose information on intangibles, including information on intellectual, human, social and relationship capital. This dimension is a key component of financial materiality.
- 7 Enterprise value is defined - *Reference: Reporting on enterprise value Illustrated with a prototype climate-related financial disclosure standard (December 2020)* - as market capitalisation (shareholder value) plus the market value of net debt. It is determined by capital market participants, based on their estimation, of the present value of expected cash flows, spanning the short-, medium, and long-term. Essential inputs in determining enterprise value include corporate reporting in financial statements and in sustainability-related financial disclosures. The term was deliberately chosen because it is widely used and is technically specific in capturing the notion of expected value creation over time for the company's equity and debt investors (which is emphasised to be distinct from, but fundamentally interdependent with, value creation/erosion for the company's other stakeholders).

The accounting and financial reporting fundamental concepts

- 8 **This section describes the key concepts underpinning financial reporting recognition.**
- 9 Financial accounting and reporting are based upon conceptual frameworks which guide the recognition of assets and liabilities as well as, in parallel, the recognition of revenues and costs ("double entry" system). This can be illustrated for instance by the non-binding Conceptual Framework of the IASB as well as by the underlying concepts of the EU Accounting Directive.
- 10 Recognition for financial accounting and reporting purposes implies that the following well established criteria are met:
 - (a) Assets have to be identifiable and under the control of the reporting entity as a consequence of past events. They are directly related to existing cash balances (or equivalent) of the reporting entity or future cash inflows for the reporting entity deriving from the control of other forms of assets. For example:

- (i) Customer balances represent commitments received from third parties (customers) to pay cash amounts due to the reporting entity against the delivery of goods or services by the reporting entity in past periods. Customer balances are legally enforceable.
 - (ii) Inventories represent capitalised costs that have been incurred by the reporting entity in past periods to acquire, transform and assemble resources necessary to produce goods or services that will generate revenues and the related cash inflows through sales in future periods. Inventory items are owned by the entity, the transfer of ownership to customers takes place at the time of the sale.
 - (iii) Fixed assets represent capitalised costs that have been incurred by the reporting entity in past periods to acquire or produce resources that will be used in order to produce goods and services over several production cycles. Fixed assets are under the control of the reporting entity and generate future benefits.
- (b) Liabilities have to correspond to commitments (obligations) from the reporting entity vis-à-vis third parties deriving from past events. They are directly related to existing cash debts (or equivalent) of the reporting entity or future cash outflows for the reporting entity. For example:
- (i) Supplier balances represent commitments made vis-à-vis third parties (suppliers) to pay cash amounts due by the reporting entity against goods and services received in past periods. Suppliers have a legal claim against the entity.
 - (ii) Provisions correspond to existing or likely obligations for the reporting entity to incur in future period cash outflows the precise amount of which has to be estimated by the reporting entity.
- (c) Liabilities are considered for recognition by way of provisions when the related outflows are more likely than not.
- 11 Once recognised on the basis of past events (retrospective approach) the measurement of assets and liabilities may have to take into account forward looking information related to the use or recoverability of recognised assets or to the extinguishment of recognised liabilities. Forward looking information is used to confirm or modify the initially recorded amounts, estimates are particularly important for the measurement of long term assets or liabilities:
- (a) Assets must be impaired when it is likely that the expected cash inflows do not justify the amount recorded in the balance sheet. An impairment is recorded when it becomes likely that the full amount of the recognised asset will not be recovered, i.e. will not generate cash inflows at least equivalent to the recorded amount. As long as the asset is generating positive net cash inflows over and above the balance sheet carrying amount, no impairment is necessary. As a consequence the mere variation of the expected net cash inflows is not considered for financial accounting and reporting purposes as long as it remains equivalent to or greater than the carrying balance sheet amount (in comparison).
 - (b) Beyond the likelihood of the related obligation, provisions may need to be re-estimated on the basis of forward looking information, i.e. the expected evolution of facts and circumstances leading to the extinguishment of the liability. By contrast with the approach followed for impairment analyses re-estimating the related cash outflows has a direct impact on future cash flows: a modification of the balance sheet carrying amount is necessary as soon as the expected cash outflows differ from the ones previously estimated.
- 12 Financial profit is defined as the difference between recognised revenues and costs which is equal to the variation of the difference between recognised assets and recognised liabilities ('net assets').
- 13 The concept of control is also critical to define the operations that the reporting entity shall report upon under a consolidated approach. Only those entities that are controlled by the reporting entity are included in the scope, others forms of relationships are not directly considered as an integral part of the group managed by the reporting entity.

- 14 Finally, all the above apply under the umbrella of a so called 'mixed model' which combines, mostly on an activity by activity basis, the historical cost convention (for most non-financial activities and certain financial activities) and the fair value convention (principally for financial activities). Both conventions have advantages and disadvantages in terms of relevance. However for those activities reported upon under the historical cost convention this leads to take into account losses as soon as they are likely and gains only when they are realised. This is often described as the concept of prudence which promotes a conservative depiction of the reporting entity's position and performance.

The informative qualities and clear borders of financial reporting

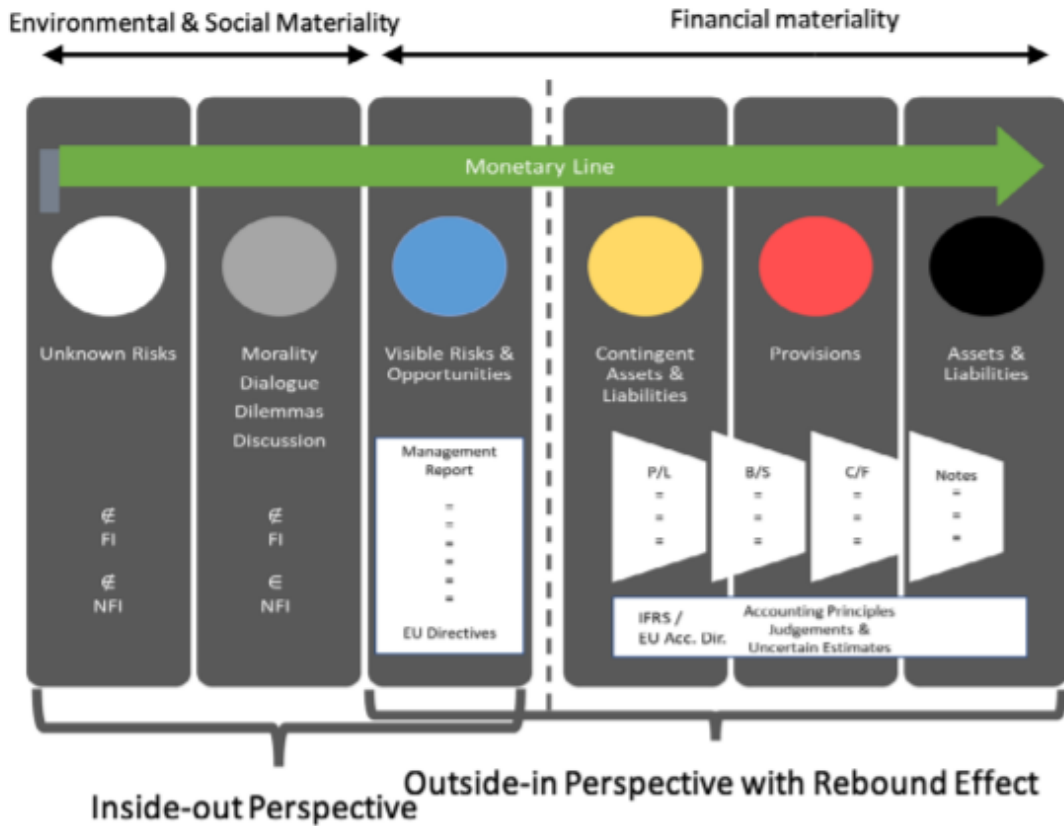
- 15 **Financial Reporting, either derived from IFRS Standards or from the Accounting Directive, is characterised by rules about recognition (and measurement) that guide the elements (assets, liabilities, income and expenses) to be included in the primary financial statements or reported in the notes. Those rules limit the possibility of including supplementary elements that are needed to assess the reporting entity's enterprise value creation.**
- 16 The principles followed for the recognition of assets, liabilities, costs and revenues for financial accounting and reporting purposes put a strong emphasis upon three key dimensions of the financial position and performance of the reporting entity:
- (a) A focus on separability, control and likelihood,
 - (b) For items measured on the basis of cost, a focus on prudence, and
 - (c) A focus on past positions and performance.
- 17 This emphasis creates a relatively high degree of informative quality about past cash inflows and outflows and future cash inflows and outflows deriving from past events (the unwinding of the position described in the balance sheet). This is one of the major interests of the financial accounting and reporting system put in place over decades and a robust basis for the understanding of reporting entity's situation and evolution.
- 18 Any initiative to move away from those dimensions at financial standard-setting level should be considered carefully in order to avoid blurring the well understood significance of financial reporting:
- (a) Financial reporting has reached a stage of stability and acceptance which is a key asset. Conceptual evolutions are potentially destabilising. The possibility of extending the recognition of assets beyond what is identifiable and controlled by the reporting entity or of extending the recognition of liabilities beyond what is the consequence of a commitment for the reporting entity or to expand the use of fair value has been envisaged. However this has finally been ruled out by the IASB and the European legislator. It would indeed increase uncertainty and create a gap between what is reported and the critical understanding of cash flows.
 - (b) The consequences of the above concepts in terms of informative quality of financial reporting may indeed give rise to disclosures in the notes to the financial statements which to a certain extent foster a better understanding of the position and performance of the reporting entity (for instance on unrealised gains). However, there is a limit to this exercise: too many disclosures may blur the basic goals of financial reporting by creating confusion on the fundamental meaning of financial statements.
 - (c) Progress in the informative quality of financial reporting should be considered primarily from a connectivity with sustainability reporting perspective through the provision of clear "anchor points" (in the notes) creating a seamless informative track with sustainability reporting (going both ways).
- 19 The counterpart of this relatively high degree of informative quality about key cash flows is the consequential existence of three clear borders of financial reporting.
- 20 The first border excludes from financial reporting facts and circumstances that have not reached the stage of being "more likely than not" for financial accounting and reporting purposes:

- (a) On the asset side, any decrease in expected profitability derived from an asset will in principle not be captured by the financial statements as long as the profitability remains positive. It means that risks on the business model of the reporting entity triggering a decline in profitability will only be considered when the decline is such that the asset becomes loss-making. Before a loss-making situation becomes likely there are many stages of potential decline in profitability that can exist and which are not considered in spite of the fact that this is a highly valuable information from a financial perspective.
- (b) On the liability side, any risk that is not the consequence of a past event or that, being related to a past event, does not represent a « more likely than not » commitment for the reporting entity shall be ignored. In business situations there are many circumstances where the risk cannot be excluded but has remote probability to materialise, or its probability or quantitative impact is difficult to assess. For example free (or cheap) access to natural capital does not create a liability for the reporting entity, whatever the related economic or social cost can be, since there is no (or only limited) cash outflow.
- 21 The second border excludes from financial reporting (i) factors of value creation that are not separable and/or under the control of the reporting entity, both in terms of existence and positive and negative evolution, as well as (ii) the potential upside (related to opportunities) of recognised assets (as compared to the balance sheet carrying recorded on a cost basis).
- 22 On the unrecorded factors of value creation:
- (a) Many internally created intangible assets are key 'capitals' of the reporting undertaking. For example: human capital, relationship capital, organisational capital, intellectual capital... They often represent the major part of the enterprise value, well over and above the net assets of the reporting entity as established through financial reporting.
- (b) They are not recognised as assets since they do not meet the conceptual criteria for recognition. As a consequence, the costs incurred to generate those intangibles are considered as expenses (with a few exceptions), their existence is not reflected through financial reporting. Their variation in terms of cash flow potential (positive as a consequence of opportunities or negative as a consequence of risks) is not reflected either. There are situations where sustainability factors that may negatively impact the enterprise value are not considered: externalities may translate into outside-in financially relevant risks in the future. For example, the conditions to access natural capital may translate at some point in the future in higher costs to access or unavailability of natural capital.
- (c) By contrast with the above treatment of internally created intangibles acquisitions of other entities give rise to the recognition of goodwill as an asset by the reporting entity. Goodwill is the difference between the purchase price and the identifiable and controlled assets minus liabilities. Goodwill represent non identifiable and/or non-controlled assets. This is an identified paradox of financial reporting.
- 23 On the potential upside aspect of recognised assets:
- (a) The evolution of the conditions related to the ownership or use of certain assets may trigger an opportunity to increase the derived cash flows beyond the amounts considered at the time of their acquisition.
- (b) Financial information gives no or limited information about such situations. For items measured at cost, the principle of prudence focuses on possible downside situations relating to recognised assets when they are getting close to loss-making situations, potential re-evaluations to reflect upside situations are not considered.
- 24 The third limit to be considered is the retrospective approach on which financial reporting is based.
- (a) By conceptual design financial reporting provides very limited information on the impact on future cash flows of potential changes in the conditions under which the reporting entity will develop its activities and will as a consequence generate cash flows. The only forward looking dimension is related to the re-measurement of assets and liabilities as illustrated above.

- (b) Future cash flows cannot be predicted from past cash flows only, even if past cash flows are a key starting point and a good ‘anchor point’ for any forward looking analysis. Potential or expected changes in the conditions prevailing in the past are to be considered, in particular when the facts and circumstances under which a reporting entity operates evolve rapidly.
- (c) As a consequence, the evolution of the business model is a key factor to understand the cash flow potential of a reporting entity. The evolution may go both ways: towards a decrease (risks exceeding opportunities) or an increase (opportunities exceeding risks) of cash flow potential.

25 Figure 3 below provides an illustration¹ of the dynamics of a non-financial factor becoming financially material for financial reporting; to be read in conjunction with paragraphs 32 to 34 below.

Figure 3



Input from financial analysis on enterprise value creation (and financial materiality)

- 26 Financial analysis as well as academic and empirical research confirm the need to go beyond financial reporting in order to better capture enterprise value creation.
- 27 Most valuation models operate from discounted cash flows from the operations developed by the reporting entity. This is related to investment modelling: the return on an investment is the ratio between the cash spent and the cash received over a period of time (plus a terminal value, if any). There may be other models, but they are simplified versions of or practical expedients (or proxies) for discounted cash flow models.

¹ Ref. EFRAG PTF NFRS Report March 2021 – Appendix 4.4 Stream 4 Assessment Report.

- 28 In this context financial reporting as it stands, i.e. on the basis of the adopted and well established concepts, is considered critical, but not sufficient, to determine what future cash flows will look like. As a consequence other factors have to be introduced in the analysis in order to benefit from credible forecasts. Analysts tend therefore to identify the factors that will influence cash flows (and profitability) and then to quantify their impact. Those factors are sometimes described as 'pre-financial' since they (i) are not (cannot be) recognised by financial accounting and reporting systems but (ii) will ultimately affect financial statements and cash flows at a point in time (once they materialise in terms of assets or commitments, and then in terms of cash...).
- 29 As illustrated, for example, by the Integrated Reporting² Framework developed by the IIRC which a good synthesis of the thought process developed to approach value creation mechanisms, those factors which are financially material may be called «capitals» and may be categorised as comprising:
- (d) financial,
 - (e) manufactured,
 - (f) intellectual,
 - (g) human,
 - (h) social and relationship and
 - (i) natural capitals.
- 30 Such a categorisation is to a certain extent conventional and other classifications may be proposed by other frameworks; however it represents a reasonable and acknowledged inventory of influential factors.
- 31 Beyond the above six categories, capitals may be further subdivided through two focuses:
- (a) The **focus on stocks vs flows of capitals**. Stocks describe the capitals in use by the reporting entity at a reporting date. Flows measure the increase or decrease of capitals over a period of time. Flows can be measured retrospectively or prospectively.
 - (b) The **focus on financially recognised/disclosed vs financially unrecognised/not disclosed capitals**. This focus is the direct consequence of the above described financial accounting and reporting concepts. Integrated reporting tends to put the emphasis on complementing financial reporting. Generally financial and manufactured capitals are considered as properly reflected through financial reporting, so in order to identify the area of sustainability related financial materiality, the emphasis is upon the other four capitals (intellectual, human, social and relationship and natural capitals).
- 32 As a priority, in order to determine the key trends in terms of future cash flows, analysts tend therefore to investigate the prospective evolution of capitals that are not recognised nor disclosed via financial reporting.

The relationship between the two dimensions of double materiality

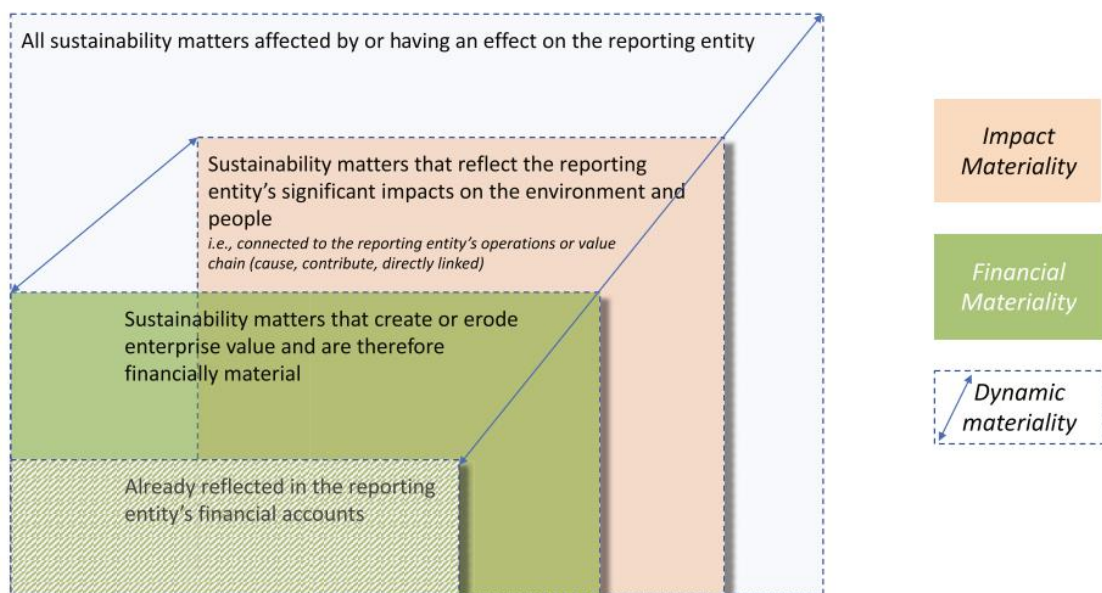
- 33 Financial-related sustainability materiality can derive from two sources:
- (a) The reporting entity is affected by external factors (outside-in materiality) that influence its position, development and performance. A classic example is climate change for activities with limited or low GHG emissions. The reporting entity may have limited or no responsibility in terms of climate change and still see its activities heavily impacted (currently or potentially) by climate change. The reporting entity needs to adapt its business model to the new conditions. Adaptation may trigger adverse (inside-out) impacts. Such interaction implies extra attention.
 - (b) The reporting entity generates significant impacts on environment and/or society (inside-out materiality) and two very different situations in terms of financial related to sustainability materiality may be observed:

² . [IR-Background-Paper-Capitals.pdf \(integratedreporting.org\)](#)

- (i) As a consequence of its inside-out impact the entity is itself exposed to significant outside-in impact ('rebound' or 'boomerang' effect). In this situation there is a direct incentive for the reporting entity to mitigate the inside-out impact. E.g. for a company in agriculture, the consequences of depleting land and biodiversity of a field could directly affect the yield of the crops and hence the financial margin.
- (ii) The entity has no rebound effect. In this situation, which is probably more common, there is a temptation for the reporting entity to ignore the issue and to maximise its own financial creation at the expense of damage to environment or society. Such situations are sensitive and justify extra attention from a sustainability reporting perspective.

- 34 Impact materiality (inside-out) and financial-related sustainability (outside-in) materiality have to be considered independently in a cumulative manner. However there may be significant interactions. In such a context it is important to analyse sustainability subject matters from both angles taking into account the existence or not of interactions.
- 35 The graph below is often used to provide an illustration of this concept³. The focus of this Appendix is the dark green area, i.e. financial materiality for sustainability reporting.

Figure 4



How to approach financial materiality for sustainability reporting?

- 36 Approaching the sustainable development of a reporting entity from a financial standpoint implies embracing all factors that contribute to its long-term development, performance and position. Under a simplified but pragmatic approach sustainability reporting starts beyond the borders of financial reporting.
- 37 In order to cover the corporate reporting space beyond the financial reporting borders, four sustainability disclosure areas (potential items pre-financial or financial to be disclosed) can be identified. The first two are related to recognised assets and liabilities. The last two are related to 'capitals' that are not recognised by financial accounting and reporting but have a significant influence on the performance and value creation of the reporting entity.

³ Impact management project.

Sustainability disclosure area 1

*Positive or negative likely impacts on future cash flows of recognised assets and liabilities, resulting from **past events** but with effect on future cash flows not yet recognised (below the more 'likely than not' criterion).*

- 38 From a sustainability reporting perspective this area covers situations where there are past events justifying a concern (risk), but where the likelihood does not meet the 'more likely than not' criterion applicable to the impairment of an asset or the booking/increase/decrease of a liability from a financial accounting and reporting standpoint. This also leads to addressing situations where, whatever the likelihood, there is an upside potential which is not captured under the principle of prudence (under the historical cost convention) for financial reporting purposes. The goal is different for assets and for liabilities:
- (a) From a measurement of assets perspective, the goal is to approach the increase/decrease of the expected cash flows to be derived from the control of the asset in situations where the likely net cash flows remain positive (i.e., do not justify an impairment).
 - (b) From a liability estimate perspective, the goal is to approach the possible future cash flows resulting from situations that are not 'more likely than not' and are not recognised.
- 39 To cover this disclosure area, we can envisage two steps:
- (a) *Step 1. Situations more likely than not:* The objective is to offer an additional layer of information on the current risks and opportunities related to 'stocks' of assets and liabilities recognised by financial reporting. The key question for this step is: what is the current expected trend in terms of net cash flow generation from recognised assets that are not in an impairment situation? This should cover situations of likely decrease (or increase) of cash flow generation from assets that are not already considered for accounting purposes as generating a negative (or positive) net cash flow in future periods. The decrease or increase is derived from scenarios (forecasts) that are deemed likely to materialise. Disclosures may address assets at risk only or be more comprehensive and identify potential upsides as well.
 - (b) *Step 2. Situations not more likely than not:* The objective is to offer an additional layer of information on the streams of positive or negative future cash flows, for which the occurrence of risks and opportunities is currently not considered 'more likely than not'. The key question for this step is: what are the financial effects that may derive from such risks and opportunities which do not meet the condition to be recognised? This should cover situations where the likelihood is below the 'more likely than not' level (even if judgmental) but still significant and should go one step beyond disclosure area 1, which is designed to add disclosures on scenarios that are 'more likely than not' but relate to assets/liabilities already recognised.

Sustainability disclosure area 2

*Possible financial risks or opportunities affecting recognised assets or liabilities (i.e. positive or negative likely impacts on future cash flows) that may result from **future events**; their effect on future cash flows is not yet recognised (not deriving from past events).*

- 40 From a sustainability reporting perspective, this disclosure area covers situations where the likelihood (intensity of risks or opportunities) is expected to increase or decrease as a consequence of future events. Likelihood of financial impact is not static and will evolve as a consequence of future events:
- (a) Those future events can be external to the reporting entity (e.g. an anticipated new regulation).
 - (b) They can also be internal and related to decisions to be taken by the management of the reporting entity. It is the essence of management to minimise risks and to maximise opportunities in a given external context.

- 41 The objective of disclosure area 2 is to give relevant information on possible (future) events affecting the cash flow generation potential of the reporting entity in relation with assets and liabilities that are or can be recognised through financial reporting. The focus is on tracking emerging or potential situations which following the occurrence of future events may translate into:
- (a) The impairment of an asset,
 - (b) The recognition of a liability,
 - (c) The decrease/increase in net cash flow generation potential of an asset.

Sustainability disclosure area 3

Disclosure on the currently used capitals that contribute to the creation/maintenance of enterprise value. They do not meet the accounting definition of assets (liabilities) and/or the recognition criteria, but are related to past events.

- 42 The key question for this disclosure area is: what is the assessment in terms of currently used 'capitals' which are not recognised as assets from a financial recognition standpoint? This leads to address the situation of 'capitals' that are not recognised as assets from an accounting and financial reporting standpoint but have a significant influence on financial performance. The primary goal is to identify those factors of value creation that play a material role in the financial performance of the reporting entity and then to disclose their key features. As explained above:
- (a) These items cover factors of value creation that do not meet the separability and control criteria applicable for the recognition of an asset (or liability).
 - (b) They are multifaceted. For instance: intellectual, human, social and relationship, natural.
 - (c) To start with they can be approached in terms of position at the reporting date (stocks).
 - (d) Monetisation is not the only possible measurement. Many metrics of a narrative and non-monetary nature may illustrate the existence and magnitude of 'capitals'.
 - (e) As for recognised assets and liabilities, the level of likelihood plays an important part here as well: what is the likelihood of the reporting entity receiving financial benefits from the existence of the identified 'capitals'? For 'capitals' the likelihood can also be either over and above or below the threshold of 'more likely than not'; however there is no need to decide on a monetary value which is necessary for recognition under accounting and financial reporting concepts.
- 43 The objective of disclosure area 3 is to provide relevant information on 'capitals' that cannot be recognised as assets through financial reporting, but have a significant influence on the financial performance of the reporting entity. What are the relevant 'capitals' to describe and what are the narrative disclosures and metrics (of a monetary or non-monetary nature) that reflect their current contribution to the cash flow generation of the reporting entity? The focus is on the description of the key features which illustrate on the reporting date the existence and magnitude of the identified 'capitals' as a result of past events. Since many disclosures (on stocks of 'capitals') are of a narrative or non-monetary nature, the question of likelihood is of lesser importance than for financial reporting assets: nuances in terms of magnitude are possible, the answer is not binary (recognition or not). This does not have to be translated systematically into a monetary amount.

Sustainability disclosure area 4

Disclosure on the future expected developments (related to future events) to the used capital factors that contribute to the creation/maintenance of enterprise value.

- 44 The key question for this disclosure area is: What are the possible events that may have an influence on the evolution of the 'capitals'? Beyond the existence of stocks of 'capitals', it is key to track flows of 'capitals' to understand better the current and expected financial performance of the reporting entity (impact on retrospective and/or prospective cash flows). As regards the expected evolution, the reasoning is similar to the one followed for recognised assets (see disclosure area 2).

- 45 The objective of disclosure area 4 is to assess the retrospective evolution of the 'capitals' and, more importantly, to analyse the possible impact of future events on the 'capitals' (identified and described in terms of stocks through disclosure area 3). As regards the prospective dimension the focus is on assessing the risks and opportunities related to the 'capitals' that are critical to the sustainable development of the reporting entity. In this respect the likelihood criterion is more important than for the description of stocks but the nature of the disclosures (narrative, non-monetary, monetary) should help translate accurately the gradation of the exposure of the reporting entity to risks and opportunities.
- 46 In conclusion, the proposal is to cover the four disclosure areas, to contribute to 'reduce the gap' between financial reporting on the one hand and medium/long term cash flow forecasts on the other hand. It is indeed a contribution to 'reduce the gap' since progress on disclosures can be expected to foster a better understanding of sustainable performance and value creation but will not capture all the elements leading to the ultimate value creation and fully 'fill the gap': the ultimate value is different from the sum of the elements and encompasses subjective elements that are extremely difficult/impossible to measure.

How to identify critical 'capitals' as possible triggers of financial impacts?

- 47 The triggers to be considered are related to the business model of the reporting entity. The materiality assessment exercise is the process through which the reporting identifies those ESG factors ('capitals') that have or may have an effect on its enterprise value in the short/medium/long term.
- 48 In line with the 'capitals' mentioned above, the following key questions can be considered. The answer to these questions will support the identification of possible risks and opportunities and related financial effects.
- (j) Will the entity be able to continue to use the resources needed in its productive process (including workforce, i.e., human capital)? Inter alia:
 - (i) market for the resource and available supply,
 - (ii) pricing and margins,
 - (iii) resource degradation and remaining useful life, the maintenance or recreation of ability and costs
 - (iv) policy/regulatory constraints.
 - (k) Will the entity be able to continue to rely on the relationships needed in its productive process in the same terms as is currently done? Will the entity's practices trigger an adverse (behavioural or other) reaction? Inter alia:
 - (i) financial institutions and providers of financial capital,
 - (ii) supply chain,
 - (iii) customers (competitive/ethical behaviour, privacy, satisfaction, product impact on health, marketing and communication, product safety),
 - (iv) external stakeholders,
 - (v) broader society/communities.
 - (l) Will the entity be able to continue to influence the natural and social capital in order to be able to pursue its own sustainability and financial goals? Inter alia:
 - (i) availability of sustainable sources,
 - (ii) tolerability of the negative externalities produced by the entity,
 - (iii) brand and reputational consequences.

How to rate the level of likelihood (materiality) of sustainability financial related impacts?

- 49 There are different possible methods to rate the level of likelihood/materiality. Most of them are somehow empirical, they are either (expert) consensus driven or based upon a rational gradation corresponding to the successive steps towards the materialisation of an impact (i.e., an effective cash outflow or inflow).
- 50 The proposed approach is inspired by a Harvard⁴ research paper. The basic idea is the following. Often, there exists a degree of misalignment between the interests of business and the interests of society. In the pursuit of profit businesses may take actions which negatively impact society, either directly through their products (e.g. the public health effects of tobacco use) or through their operations, often viewed as externalities (e.g. the promotion of climate change through the release of greenhouse gases). ESG issues become financially material following a reaction of either the company or its stakeholders to a perceived unbalance between societal benefits (e.g. job creation) and costs (e.g. negative externalities) of the reporting entity.
- 51 Under the proposed approach, each of the selected factors that are potentially financially material could be ranked in the following successive classes:
- (a) Not material: for all the industry, negative impacts on broader society are perceived to be lower than societal value created by the entity.
 - (b) Low materiality: there is isolated evidence of corporate behaviours that are capturing advantages (positive or negative) in the cost/benefit societal trade off.
 - (c) Medium materiality: corporate behaviours reach the maximum tolerable level. There is evidence of corporate behaviours triggering adverse reactions from stakeholders or the access to the initial advantage is so widespread by other entities that there is not any more competitive advantage,
 - (d) High materiality – sector: market practices emerge that aim at rebuilding stakeholders' trust; self regulation.
 - (e) High materiality – across sectors: the issue is integrated in the competitive landscape; policy intervention.

⁴ How ESG Issues Become Financially Material to Corporations and Their Investors? David Freiberg, Jean Rogers, George Serafeim – 2019/2020 Harvard Business School