DOUBLE MATERIALITY ASSESSMENT (DMA)

Misconceptions, Explanations and Examples

A White Paper by

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DHC

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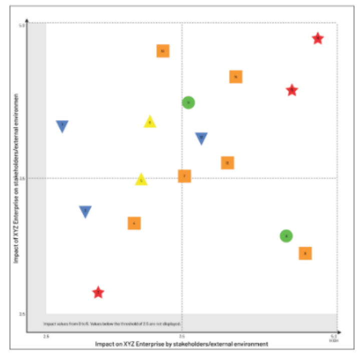


Executive Summary

The EU's Sustainability Reporting Standards will require reporting and disclosures based on results of a Double Materiality Assessment (DMA). What was once discussed among academics and an element of voluntary reporting standards is now mandatory for some companies. Since Sustainability data travels up and down the value chain, this requirement will affect thousands of companies of all sizes worldwide. Consultants have explained DMA in thought leadership pieces – but they're not all aligned.

Mr. Hileman[1] is an author of COSO's "Achieving Effective Internal Controls over Sustainability Reporting (ICSR)", a landmark reference to bridge the divide between those who know "internal controls" (Accounting, Controller, Finance, Internal Audit), and those who don't (Environmental, Human Resources, Operations, Procurement. Etc.). Perspectives in this white paper are intended to help bridge that gap for DMA and to fulfill the reporting requirements that will follow.

Introduction

Sustainability professionals should learn to talk the language of the Board and the C-Suite. Finance, Accounting, Internal Audit, and Controllers play an increasingly prominent role in reporting and disclosures to capital markets. They also have a role in engaging external resources.

I've read several publications in the EU's Sustainability Reporting Standards, and key concepts required to achieve these disclosures. Some points have been useful, others – not so much. Or wrong. I offer some perspectives to help companies prepare for more extensive Sustainability reporting and disclosure requirements, particularly as imposed by the EU and/or capital markets. "Materiality" has always been difficult to explain, adding "double" makes it more than twice as hard. Let's dive in.

[1] Mr. Hileman is president of Douglas Hileman Consulting LLC (DHC). The perspectives and opinions are his own, and do not represent those of any client, professional association, or group he is involved with.

DEFINITIONS OF "MATERIALITY"

The EU's Sustainability Reporting Standards (ESRS) puts meat on the bones of the EU's Corporate Sustainability Reporting Directive (CSRD). CSRD/ ESRS requires entities that meet specified criteria to report on Sustainability topics based on the results of a **Double Materiality Assessment (DMA)**. The DMA requires assessment of financial materiality a nd impact materiality. The DMA goes beyond the traditional "inside out" view of [financial] materiality, adding an "outside in" perspective from key stakeholders. Once the company lands on the topics, there are required and suggested disclosure parameters[2].

Financial Materiality

One Sustainability specialist recently wrote that an item is financially material if "it is the deciding factor for an investor's decision (emphasis added)." This is a misconceptions about financial materiality.

The U.S. Supreme Court tackled the issue of financial materiality in TSC Industries, Inc. V. Northway, Inc. in 1976, in a case involving securities fraud. Justice Thurgood Marshall wrote the opinion, with a test as follows: an omitted fact is *material* if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. Not all matters that anybody *might* consider important. Not the fact (or omission) *that would determine* a court of action. [all emphasis added.]

The Global Reporting Initiative (now GRI) was founded in 1997, after public outcry from the Exxon Valdez oil spill. GRI[3] established disclosure topics and parameters, and advocated voluntary reporting. Advocates for Sustainability (and environmental, and human capital, and many of the topics that collectively comprise "Sustainability") had been clamoring for mandatory disclosures for years that investors would find useful. Nothing happened, at least in part due to the confusing array of disclosure topics.

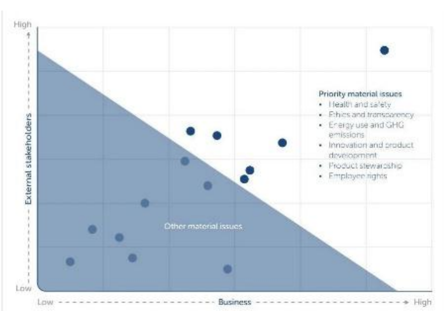
[2] The EU has released Omnibus proposals that would affect ESRS reporting and disclosures. The Omnibus proposals would raise reporting thresholds for smaller and medium sized entities, provide extensions to some parties to comply, and provide relief from some details of disclosures. DHC encourages affected parties (companies, their suppliers, and other stakeholders) to follow developments of the Omnibus proposals. Nonetheless, DHC believes the perspectives offered herein will help.

[3] GRI still exists; GRI reporting remains voluntary.

The Sustainability Accounting Standards Board [(SASB)](#) was founded in 2011, with a mission to create sustainability disclosure standards that would provide transparency and consistency for the capital markets. SASB's mindset was (my words, not theirs), "Fine. If you can't figure it out, we will figure it out for you." SASB proceeded with two foundational premises: 1) Different sectors and industries were involved in "Sustainability" in different ways; and 2) If the information were to be "decision-useful" for capital markets, then disclosure requirements should be limited to topics that would be considered "[financially] material" as already defined and established by U.S. law: the U.S. Supreme Court decision in the Northway case.

Misconceptions About Financial Materiality

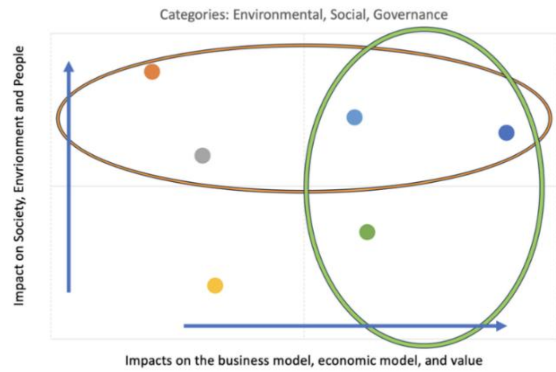
- **Misconception: Everyone's expectations will be achieved.** SASB was among the organizations rolled into the International Sustainability Standards Board (ISSB), an arm of the International Financial Reporting Standards entity. ISSB published [ISSB S1](#) "General Requirements for Disclosure of Sustainability-related Financial Information" in June 2023, to take effect January 1, 2024. IFRS S1 maintained SASB's concept of [financial] materiality. What originated as a U.S.-centric concept is now global. ISSB S1 further stated that the standards are for "primary users of general purpose financial statements[4]." Not *every* investor, not every *prospective* investor, and not every topic.



- **Misconceptions: It's all about the numbers. And it's only about the past.** It can be qualitative. In fact, one issue in the Northway case involved an executive's involvement in a company targeted for acquisition. Qualitative items that could be financially material could include pending or threatened litigation; key assumptions in making estimates; or discovery of illegal payments to government officials.

[4] ISSB released S2 on the same day. ISSB S2 pertains to disclosure of climate-related risks, including metrics (e.g., Greenhouse Gas (GHG) emissions inventory).

- **It's the same every year.** Companies change. So does financial materiality as it is applied to those companies. Companies grow by acquisition, or sell divisions. A fabulously profitable product one year can spawn imitators, reducing profitability. A court decision on product liability could impair profits for years to come.



Impact Materiality

Impact materiality involves impact the organization has on other parties. **Double materiality assessment** includes assessing the materiality of impact. It can be a non-trivial exercise to identify these impacts, let alone assess them. Where is the impact, how, and to whom? How does the organization know about these impacts? How big are they? Is it possible to mitigate or eliminate adverse impacts? Could the impacts be permanent?

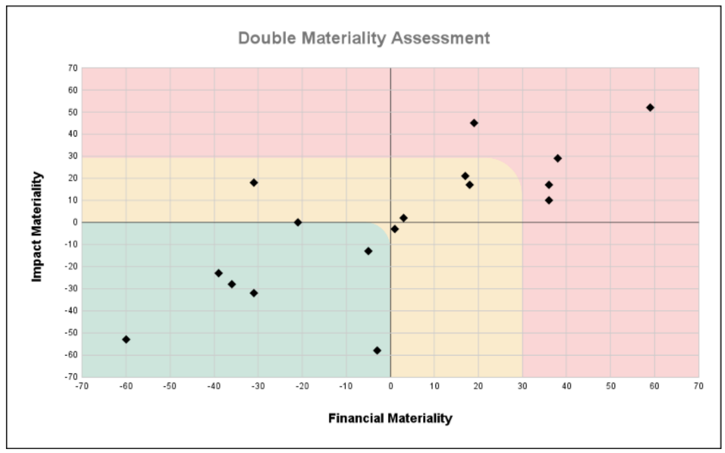
Impact materiality is a relatively new concept. Companies are turning to external resources for help in identifying and assessing impact materiality. DHC suggests that complete reliance on an external party in a new/ emerging field could pose some risk. DHC offers perspectives on selected FAQs.

Misconceptions About Impact Materiality

- **We have to consider everything and everyone.** Stakeholder engagement is many things. Some information will already be available. Prior efforts supporting Sustainability reports are a good start. So is data and information from calls to hot lines. The company may perform investigations on lapses in compliance and ethics. Internal audits can identify impacts to stakeholders. A good compliance register can offer clues, especially if paired with the SASB/ ISSB disclosure standards. Financial services, health care, and chemical sectors are heavily regulated for cybersecurity, privacy, and environmental & safety regulations, respectively. These matter to stakeholder groups: customers, creditors, neighbors, and the environment. or data on grievances. Internal audit and investigations identify root causes of lapses in compliance and ethics.

- **It's different from Risk.** What's different is how it's applied. Impact is "inside out" – what does the organization do with impact on others? The greater the impact, the more likely it will be a candidate for Sustainability reporting and disclosures. The likelihood is different; it's from the perspective of impact *on the stakeholder* – not the organization.

- **It is completely separate from financial materiality.** Impact assessment starts with identifying stakeholders (including inanimate items – like the environment itself). Then identify the impact of a company's activities on those stakeholders. The impact may arise directly from a company's activities. Impact can also arise from the supply chain, or due to the inherent nature of the company's business. These impacts are usually mapped on the classic 2x2 grid, with financial materiality and impact materiality on the two axes. As with traditional risk assessment, points in the upper right area of the grid command the most attention. These topics are material from both a financial and an impact perspective.



Now What?: Selecting the Topics

Which topics are sufficiently "doubly material" to warrant reporting and disclosure per ESRS? Consultants may provide their recommendations, and suggestions based on "best practices." What is best practice? And best *for whom*? Who decides?

Nonetheless, DHC suggests it's an excellent time to align with your company's existing approach to risk identification, assessment and management. A company with a high risk appetite may select only the topics at the furthest tip of the northeast quadrant. A company with robust existing Sustainability reporting and disclosure efforts may select more topics. If the outcome of the DMA process differs substantially from the outcome of the classic enterprise risk management process, it begs a few questions:

- If the estimates of financial materiality differ, what are differences in the rationale that led to different conclusions?

- Were scenarios considered in one that were not considered in another?

- How different are estimates of financial impact; which basis is more reasonable?

- Are there non-financial issues, or influences from stakeholders outside the capital markets that are not ranked appropriately to enable the company to meet its objectives?
- Are the timeframes for potential financial impact the same?
- Does one method "net out" estimated [positive] value of opportunities against estimates of financial impairment[5], whereas the other doesn't?

WHY IT'S SO IMPORTANT TO GET THIS RIGHT

The DMA is a key step – but only one step – in the journey to ESRS reporting and disclosures. There are several reasons why the C-Suite, the Management Team, Sustainability specialists, and all the functional groups that provide data should want to get this right.

- **It takes longer than you think to design and implement systems and controls[6].** Ambitious scoping of disclosure topics can set a company up for a chaotic scramble.
- **It's easier to begin reporting on a new topic than to ditch an old one.** Sustainability reporting is patterned after financial reporting in many respects. For example, users expect "comparable data" – both among different companies, and year-on-year comparisons for a reporting entity. Analysts will become conditioned to look for your reporting in, say, water use, and conservation and recycling efforts. If it disappears, you may be asked why.
- **The DMA process itself may be subject to assurance.** Initial provisions of the ESRS required the DMA process to be subject to assurance. The Omnibus proposals aim to provide relief to reporting entities in many areas, and the dust hasn't fully settled. Whether assurance is ultimately required or not, the genie is out of the bottle. Some companies will obtain assurance voluntarily. Others may embed this requirement into third party risk management efforts. Document whatever you do, and be prepared to discuss it. And stay tuned to DHC for more on assurance readiness[7].

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[5] This practice of "netting out" is not generally permitted under accounting rules, or similar Sustainability reporting and disclosure standards. Consider an example of a company with $50 million in sales for a calendar year, and $20 million in returned product. It would be deceptive, to say the least, for the company to net the two our and simply report $30 million in sales. I have supported many financial audits as an environmental specialist, and hold the Fundamentals in Sustainability Accounting credential (granted originally by SASB). I say this practice is "not *generally* permitted" because I am not a CPA.

[6] The COSO ICSR guidance document is on the DHC home page, as well as the COSO website. COSO ICSR is available in Spanish, simplified Chinese, and Japanese at the COSO website. COSO ICSR is free at all locations.

[7] See also www.auditreadinesspro.com.

KEY TAKEAWAYS AND PATH FORWARD

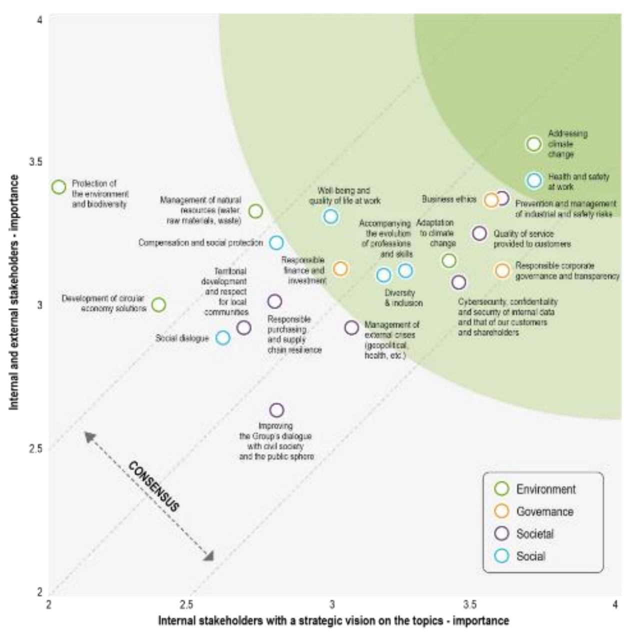
REMEMBER: IT'S YOUR COMPANY

The entity responsible for reporting and disclosures per ESRS – and any other law, regulation, contractual requirement, standard, and framework for that matter – is the company itself. Company staff responsible for these decisions may include CFO, General Counsel, Controller, and other executive management.

This group should understand the issues, the information available, the services and recommendations provided. Understand the basis for recommendations, and caveats or limitations to the recommendations.

Peer comparisons can help, but no two companies are identical. PepsiCo and Coca-Cola are famously competitive, but PepsiCo derives over half their revenues from food, whereas Coca-Cola is almost entirely a beverage company.

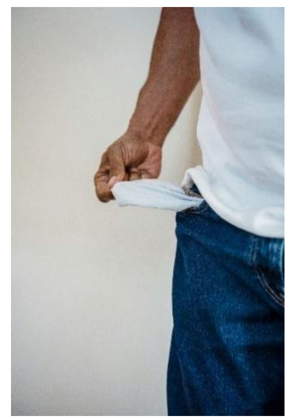
However – *and I cannot emphasize this enough* – **the decision should remain at the reporting company.**



Financial Materiality Example

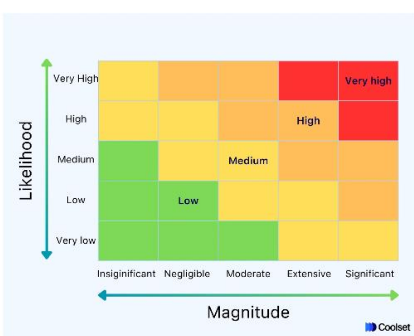
Environmental Reserves: A Tale of Two Companies

I worked at a Big 4 accounting firm for six years, beginning in the early days of Sarbanes-Oxley. Companies required to address legacy contamination are required to establish financial reserves to address them. I supported financial audit teams to get comfort in the numbers – and the processes used to obtain them.



Company A produces commodity products, and operates on a razor thin profit margin. Raw material costs vary, as do the prices Company A can obtain for their products. A variance of $100,000 can change the earnings per share by $0.01. With apologies to Forrest Gump, remediating contaminated sites is like a box of chocolates. You can see smoke plumes in the air, but you can't see contamination under the ground surface. You never know what you're going to get. Even after substantial testing, clean-up efforts and their costs involve estimates. Staff may be tempted to get creative with estimates to meet excessive pressure to make earnings targets. My audit procedures had to be extremely detailed to provide sufficient comfort to the audit team.

Company B achieved remarkable financial success, thanks to innovative technology and an impressive array of patents. Company B's annual revenues are more than $1 billion, and their gross margin is the highest of companies in their sector. Company B's only responsibility for cleaning up contaminated sites stems from an acquisition. A consultant recently estimated costs of $10 million to complete remediation in three years. The financial success of Company B is such that the materiality threshold for the audit is $30 million. If the number was too low by half, another $10 million wasn't even a rounding error. An audit is like any other project. There are budgets and expectations. The client pays attention to how the money is spent. It wouldn't make sense to spend time (and money) on an item where the outcome will have utterly no effect on the financial statements or the audit opinion. I was favorably impressed when the company and the audit team agreed that it was important to make sure things were right.



Impact Materiality Example

Bart's Barbecue: A Whimsical (and Fictitious) "Case Study"

The "double" in Double Materiality includes financial materiality and impact materiality.

Accountants have been familiar with **financial materiality** for a very long time. Financial materiality is at the core of financial auditing, and the trust we place in financial reporting and the capital markets. Accountants focus on revenues, costs, estimates, processes and controls to ensure the financial data is accurate and supportable.

Impact materiality is newer. It's an "inside-out" perspective on how operations affect stakeholders and the world, whether it has significant financial impact or not. How about a case study can illustrate the radical difference from financial materiality. My imaginary friend Bart invites us to consider his challenge.

Bart's Grocery and Barbecue

Bart's family grew a modest neighborhood grocery into a Bart's Markets, a regional chain with 100 locations. Bart's customers love barbecue. Bart began grilling meat onsite at one location. The smell draws customers, so the grills are located near the front door. Bart's has expanded to 60 locations to meet customer demand. At 20 locations with smaller store sizes, Bart's contracts with vendors to cook up barbecue in the parking lot, some in food trucks, and some in open grills. It's popular. Although barbecue accounts for 10% of Bart's revenue, it accounts for 30% of the store's profits.

Bart's must do an impact materiality assessment. Bart's needs to consider more than financial performance; Bart's needs to consider impact on employees, neighbors, nearby businesses, the wider community – even the environment itself. This is the essence of impact materiality.

The barbecues have come to their attention. Do the barbecues cause material impact? Will Bart's need to address this in reporting and disclosures? The Impact Materiality Assessment team gets to work.

Barbecue and Impacts

The smell of barbecue is "music to the nose" of meat lovers. It also generates smoke, which includes chemicals [polyaromatic hydrocarbons (PAHs)] that increase the risk of cancer. Smoke also includes particulates, which can affect people with asthma and other respiratory illnesses. None of the cooks have complained, but nobody has asked.

Many of Bart's locations are in urban areas, often in poorer neighborhoods. They have small store footprints, with little or no room for expansion. Two locations are in urban areas that require an air pollution control device for the barbecue exhaust. Each device cost $20,000 to purchase and install. Bart's estimates that the operating costs of the control device reduce the profit of the barbecue by about half.

As the Impact Materiality Assessment team began collecting information, they learned that the smoke from Bart's Barbecue is close to the air intake of preschool centers at five locations. The success of Bart's Barbecue has led to sidewalk vendors within 100 feet of many locations. These vendors undercut Bart's on price, and are much smokier than the units at Bart's.

Impact Materiality Assessment

<u>Impacts and Thoughts</u>

The DMA team lists impacts and other thoughts. They include:

- Smoke includes PAHs, which could impact the health of neighbors. The link between the barbecue and impact could be stronger in some cases (coughing) and more tenuous in others (cancers).
- Impact to sensitive neighbors (children, seniors) could be greater. There is incomplete information on how many neighbors could fall into these categories.
- PAHs in the smoke from 60 locations could impact air quality in the region.
- The company has incurred capital costs, and continues to incur operating costs for the air pollution control devices.
- Bart's employees have health insurance. Workers on the food trucks may not.
- The food trucks are only at Bart's on weekends. They are doing the same thing somewhere else every other day of the week.

- Smoke from the outdoor barbecue grills lands on employees' cars while they are at work, with some complaining they must wash their cars almost every day (using water and soap).
- Whatever the impacts might be, Bart's operations are better than the sidewalk vendors. If customers can't get barbecue at Bart's, they will be buying it from others that cause even more negative impact.

Evaluation and Assessment

The Discussion. The DMA team begins a spirited discussion about impacts – over a lunch of barbecue, of course. What are the impacts? How do you you've got them all? What is the extent of the impacts? How could they be described? What's makes an impact "material"? If everyone is doing it, why should Bart's make any disclosures at all?

That big expense! You might have noticed the $20,000 Bart's spent on air pollution control devices. I admit, this is a red herring. The capital and operating costs are relevant to the financial statements; they could be financially material. Since there are only two devices, the costs are unlikely to be financially material on Bart's financial statements. The accounting rules and controls are mature. Accounting, Finance, and auditors will navigate this with ease. But we're considering *impact* materiality. The impact is from the smoke itself and the potential effect on people and the environment. In fact, the pollution control devices mitigate this impact – but at a cost.

Red flag! Proximity of air intake for the preschools raises another red flag. If these neighbors file lawsuits – or threaten to – this risk could also become financially material. Impact materiality and financial materiality are not mutually exclusive. The impact materiality assessment can identify warning signs of issues that could ultimately cost the company a lot of money, as well as reputational damage.

What's an "impact"? Furthermore, there are different types and scales of impacts.

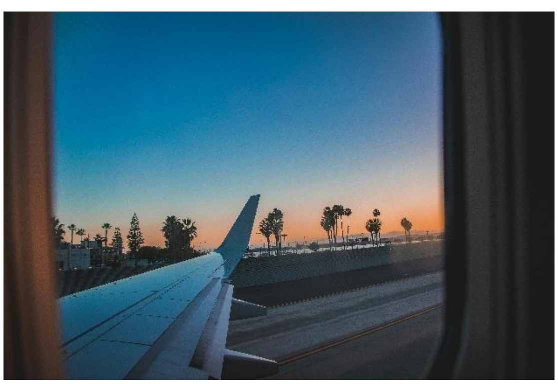
- Direct and Indirect: The smoke directly affects the neighbors. Smoke that settles on cars – and pavement and other surfaces – winds up in local waterways. This is an indirect impact.
- Short-term and long-term: Coughing and aggravated asthma is a short-term impact, while cancer risk is long term.
- Localized and regional: Impact on preschoolers is localized. The aggregated impact from 60 grills is regional.
- Varying degrees of impact: Neighbors, employees, contractors and even customers will be impacted differently. Active, growing children at the neighboring daycare may have longer-term risks as well.

Where does it end? The organizational and operational boundaries pose challenges. Accounting rules are clear on how Bart's accounts for revenues, including rent payments from the food trucks at those 20 locations. The DMA team has noted potential health impacts on employees, contractors (food truck operators), neighbors and the broader community.

The crusader. One team member is a strong advocate for clean water. They strongly advocate disclosing data on water used to wash employee vehicles, and how much goes into storm drains and local waterways.

It's unfair. So says the CEO of Burt's. We grow a successful business. We are the ones who must do the impact materiality assessment. People with grills on the sidewalk do the same thing. This is relatable. Larger companies have larger impacts. They have more resources to call attention to problems. If it becomes apparent that any problem is widespread – whether smoke from a barbecue, health insurance coverage or climate change –government regulations can create a level playing field.

Land the plane. The DMA team cannot debate these topics forever. ESRS has a prescribed list of disclosure topics. GRI is another resource for voluntary disclosure parameters. To be fair, Bart's DMA team should be aware of these lists when they begin their data gathering efforts. Consultants can support with research, more analysis, and their thoughts on "best practices." The team must focus on key questions, including scope, severity, likelihood, and stakeholder views. The decision rests with the company.



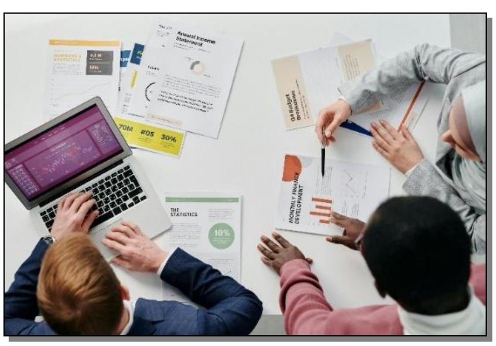
Closing Thoughts

There is no "right" answer. DHC does not provide an answer here (sorry!), because there isn't one. Companies should land on disclosure topics, document their basis for the decision, and begin designing and implement policies and procedures, and collecting supportable data where appropriate.

Consider alternatives and create better solutions – maybe a ghost? The objective of Sustainability reporting and disclosures isn't to impose another permanent reporting burden. It is to raise awareness of issues and impacts, and encourage organizations to mitigate risks and seize opportunities. Ghost kitchens have become common as an effective mechanism for centralized food preparation and delivery. These larger facilities often include state-of-the-art ventilation systems and air pollution control devices. People don't want their ramen to taste like pizza. If Bart's doesn't have barbecue grills, they wouldn't be considered in the DMA. As an ancillary benefit, they could also free up space in their properties and their parking lots.

Leverage the IMA process to add value. If you think the DMA process is only a chore and a cost, you'll be right. The IMA process at Bart's identified a risk of legal actions and/or reputational damage from neighboring preschools. Bart's can adjust operations (including the ghost kitchens) to reduce the risk. Bart's may reconsider their strategy of contracting to food trucks. If the company transitions to ghost kitchens, perhaps there will be a reduction in absenteeism due to sick days. If you think there are opportunities for the DMA process to add value, you'll also be right. But they won't find themselves.

Get help that can advocate for you, and plan for the long haul. Supplement your team with specialists who understand the issues, what it means to run a business, and can position you for success.



About Douglas Hileman

Douglas Hileman, FSA, CRMA, CPEA helps clients tackle challenges with compliance, risk, reporting, and assurance readiness on Sustainability matters (including climate disclosures and greenhouse gas (GHG) emissions inventories).

He is an author of COSO's widely-acclaimed "Achieving Effective Internal Controls over Sustainability Reporting (ICSR)". COSO ICSR is a foundational starting point for organizations building or improving programs to improve efficiency and effectiveness of their efforts, enhance value with stakeholders – and to prepare for assurance.

He draws from over four decades of experience in operations, compliance, business strategy, enterprise risk management, non-financial reporting, audit readiness, and auditing. He worked at a Big 4 firm for six years, supporting financial audits, internal audits, and other engagements involving governance, risk management, compliance. He also has nine years of experience in industry.

DHC's clients span the gamut: automotive, chemicals, energy, manufacturing, pharmaceuticals, professional services, retail, technology, and utilities. Mr. Hileman served as the senior environmental management and environmental auditing specialist on the Volkswagen Monitor team.

He has been active in the Institute of Internal Auditors, both as a Sustainability specialist and in coordinating content for local chapters and one international conference. He is a frequent speaker (Compliance Week, Society of Corporate Compliance and Ethics, professional service firms, and internal workshops). He holds credentials in Fundamentals in Sustainability Accounting (FSA), Certified Risk Management Assurance (CRMA), Certified Professional Environmental Auditor (CPEA, Management Systems focus), and a Professional Engineer (chemical).

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