In Practice

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"Double materiality": what does it mean for non-financial reporting?

Companies have been publicly reporting on their financial performance for over a hundred years. However, they are increasingly having to make public non-financial disclosures relating to sustainability and environmental, social and governance (ESG) matters as a result of rules, laws and regulations issued by stock exchanges, governments and regulators worldwide.

In the context of non-financial reporting, there has been increasing awareness of the concept of "double materiality" in recent years. In this article we clarify what "double materiality" means and provide the context of its regulatory background within the EU. We also consider the significance of "double materiality" and give our views on the potential consequences for companies of non-compliance.

WHAT DOES "DOUBLE MATERIALITY" MEAN?

The concept of "double materiality" refers to how information disclosed by a company can be material both in terms of its implications for the company's financial value, as well as the company's impact on the world at large. This relates to climate change and other environmental impacts, as well as social and human capital issues. Double materiality is based on a recognition that a company's impact on the world beyond purely financial considerations can be material and therefore should be disclosed, for reasons other than the effect on a company's bottom line.[1]

According to Matthias Tager of the London School of Economics and Political Science, determining what information is "material" depends on one's view of why information on environmental impacts should be material in the first place:

- environmental impacts could translate into financial risks, for example, through legal liabilities or harms to a company's reputation; or
- a reasonable person might consider the information material for reasons other than its direct financial impact.

To understand what double materiality means, we have to consider who the "reasonable person" is and what their interests are, which in turn helps define what counts as material and therefore what is important to them.[2] Social issues, such as human and labour rights, are also important in this context, given that a company's approach to such issues could result in financial risks for the company and are often considered to be material to investors.

REGULATORY BACKGROUND

The concept of double materiality has been incorporated into the EU regulatory framework relating to sustainability reporting, which applies to financial institutions and companies operating across the European economy.

NFRD

The EU Non-Financial Reporting Directive (NFRD) came into effect in all EU member states for accounting periods starting in 2017. It requires large "public interest entities" to disclose information on environmental, social and employee matters, respect for human rights, and bribery and corruption, to the extent that such information is necessary for an understanding of the company's development, performance, position and impact of its activities.[3] A "public interest entity" is defined as a company that is listed on an EU regulated market, a credit institution and/or an insurance undertaking, and will be in-scope of the NFRD where it has an average of 500 or more employees.

According to the European Commission's NFRD guidelines on reporting climate-related information, this reference to the "impact of [the company's] activities" introduced a new element to be taken into account when assessing the materiality of non-financial information.[4] In effect, the NFRD has a double materiality perspective:

- The reference to the company's "development, performance [and] position" indicates financial materiality, in the broad sense of affecting the value of the company. Climate-related information should be reported if it is necessary for an understanding of the development, performance and position of the company. This perspective is typically of most interest to investors.
- The reference to the "impact of [the company's] activities" indicates environmental and social materiality. Climate-related information should be reported if it is necessary for an understanding of the external impacts of the company. This perspective is typically of most interest to citizens, consumers, employees, business partners, communities and civil society organisations. However, an increasing number of investors also need to know about the climate impacts of investee companies in order to better understand and measure the impacts of their investment portfolios.

The European Commission considers that these two risk perspectives already overlap in some cases and are increasingly likely to do so in the future. As markets and public policies evolve in response to climate change, the positive and/or negative impacts of a company on the climate will increasingly translate into business opportunities and/or risks that are financially material.

CSRD

The Corporate Sustainability Reporting Directive (CSRD) will come into effect through a phased implementation for accounting periods starting in 2024. Through amendments to the NFRD, it strengthens the rules relating to the social and environmental information that companies must report.[5] The CSRD was introduced in response to criticisms that the NFRD was too limited in its scope (applying only to large public interest companies) and that its high-level approach meant that the sustainability information being disclosed was insufficient to enable investors and other stakeholders to fully assess a company's sustainability impact. The CSRD therefore extends the scope of the NFRD to incorporate small and medium sized enterprises (excluding microenterprises) that are "public interest entities" (as defined under the NFRD) and requires companies to report information on a broad range of sustainability matters relevant to their business.

Companies are therefore required to report the information necessary for an understanding of their impacts on sustainability matters, and how sustainability matters affect their development, performance and position. This provision reflects the double materiality principle by requiring companies to disclose information about how their sustainability impacts affect their bottom line as well as how their operations impact on sustainability factors.

As the CSRD is a European directive, EU member states will have to implement the rules into their local regulatory framework. It is uncertain when each member state will do so. However, the first companies will have to apply the new rules for the first time in financial year 2024, for reports published in 2025.

SFDR

The Sustainable Finance Disclosure Regulation (SFDR) came into force in two stages:

- Level 1 (which sets out the high-level requirements) in March 2021; and
- Level 2 (which contains detailed technical standards) in January 2023.[6]

It mandates the disclosure of sustainability information by financial services firms. Such firms are required to disclose information on how sustainability risks are integrated into their investment decisions. For these purposes, a "sustainability risk" is defined as an ESG event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment. In addition, firms are required to report on the principal adverse impacts (PAIs) of their investment decisions on sustainability factors, by reference to a list of sustainability indicators.

The SFDR incorporates the double materiality principle by requiring firms to disclose how they manage sustainability risks that impact on their financial performance, as well as how their investment decisions impact on sustainability factors and therefore the world at large.

APPLICATION OF SFDR

Companies incorporated in the EU

Companies already in scope of the NFRD or the SFDR should have a framework in place to comply with the disclosure and reporting requirements. As mentioned above, CSRD does not only broaden the scope of the disclosure and reporting requirements in addition to the existing requirements; it broadens the scope of companies that have to comply with the requirements.
All companies incorporated in the EU will have to determine whether they are in scope of the CSRD. In-scope companies which already report under the NFRD will have to enhance their current reporting and disclosure mechanisms, and in-scope companies not already reporting under the NRRD will need to set up a new reporting and disclosure system appropriate for their business operations, in each case to ensure compliance with the requirements of the CSRD.

Application to companies with their main business outside the EU

Certain companies operating in the EU but with their main business outside the EU are also required to carry out sustainability reporting under the CSRD. Whilst there are some exemptions from EU financial reporting requirements which apply where a company provides consolidated financial statements and consolidated management reports in accordance with equivalent requirements in its home jurisdiction, the European Commission has made clear that no such exemption regime is intended to apply to sustainability reporting requirements.[7] Although the requirements for non-EU companies with operations in the EU are more limited than those applying to EU companies, each of these non-EU companies will have to ensure that it has in place all the right mechanisms to be able to report and disclose in accordance with the requirements of the CSRD.

NON-COMPLIANCE WITH CSRD

The CSRD itself does not set out any detail on the penalties for non-compliance, so we will have to wait to see how it is implemented in EU member states to understand these consequences. However, likely consequences include:

- liability resulting from tortious claims, in particular as a result of misrepresentation and negligent misstatement; and
- supervisory enforcement actions for failing to adequately disclose material risks to investors; depending on the rules in the specific member state this may result in criminal prosecution of board members and/or liability of board members, as well as cancellation of any relevant permissions or authorisations.

In Practice

Biog box

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CONCLUSIONS

Non-financial reporting is not a magic wand which will decarbonise the planet and cure all ills.

In 2022, we had more sustainability reporting than ever before. We also had more greenhouse gas emissions than ever before.

In addition, while this article focuses on EU developments, sustainability reporting regimes are developing in other jurisdictions. This can make compliance particularly difficult for multi-national companies. It is to be hoped that the International Sustainability Standards Board will help to deliver more consistency globally.

However, non-financial reporting is starting to shine a light on issues which had been previously ignored in financial reporting. If we are to have any hope of reaching net zero by 2050 and achieving the aims of the Paris Agreement and the UN's Sustainable Development Goals, then we need to better understand the impact of our actions. For this reason, "double materiality", which forces companies to look beyond pure financial impacts, and to report on the impacts of their operations on people and planet, is to be welcomed. ■

1 Henry Engler, '"Double materiality": New legal concept likely to play in debate over SEC's climate plan?' (12 April 2022): (https://www.thomsonreuters.com/en-us/posts/investigation-fraud-and-risk/sec-double-materiality-climate/).

2 Matthias Tager, '"Double materiality": what is it and why does it matter?' (21 April 2021) (https://www.lse.ac.uk/granthaminstitute/news/double-materiality-what-is-it-and-why-does-it-matter/).

3 Article 19a, Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings.

4 European Commission, 'Communication from the Commission – Guidelines on non-financial reporting: Supplement on reporting climate-related information' (2019/C 209/01).

5 Regulation (EU) 2022/2464 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

6 Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector.

7 Please see, among others, consideration (26) of the CSRD.