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Working paper: Balancing your materiality assessment

How to move beyond the matrix

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DECEMBER 2022

Embarking on your renewed materiality journey

Identifying an organization's most important environmental, social and governance (ESG) issues is typically captured in one sweeping concept: materiality. The key issue in driving ESG strategy and performance is knowing which ESG issues are more important than others.

In this paper, we acknowledge the newness of conducting materiality analyses and the many choices organizations need to make; both sector specific and business specific. This 'working paper' (intentionally called so) shows our current interpretation of the draft standards.

Although many large companies consider regulatory changes to be a run-of-the-mill issue, the upcoming changes bring in new requirements that force businesses to rethink their materiality process.

In 2021, the Global Reporting Initiative (GRI) published a new set of reporting standards: the Universal Standards 2021, which focus exclusively on impact reporting for a multi-stakeholder audience and will be effective for information published on or after 1 January 2023*.

From FY2024 onwards, the Corporate Sustainability Reporting Directive (CSRD)** makes it mandatory for all large companies that are already subject to the NFRD in the EU, to report their sustainability performance. Within this framework, organizations are expected to not only include impact materiality perspectives (inside-out view), but also financial materiality perspectives (outside-in view) in their annual report.
This is driving many companies to revise and update their materiality assessment and underlying processes – but **where do you begin, and how do you go about it?**

We have developed this paper to provide you with an overview of the interoperability between the GRI and CSRD materiality concepts and to demonstrate how you can shape the materiality assessment to fit your business needs.

It is important to note that under the CSRD there are various detailed disclosure requirements as set out in the European Sustainability Reporting Standards (ESRS). Hence, we will use the term "ESRS" to refer to CSRD requirements in this paper. The ESRS refer to ESG issues as "topics" and "matters" interchangeably. For the purpose of readability in this document, we will use the word "topic".

** public-faqs-universal-standards.pdf (globalreporting.org)*
*** And from FY2025 (report in 2026) for remaining companies*
from FY2026 (report in 2027) for listed SMEs, possibility of opting-out until 2028
from FY2028 (report in 2029) for non-EU companies with more than 150mio turnover in EU

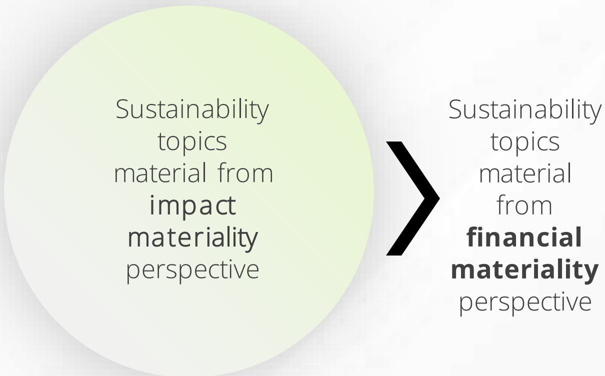
Materiality assessment

Interplay between the standards: GRI and ESRS

Two non-financial reporting standards will be in effect for reporting in the foreseeable future: the GRI Universal Standards 2021 and the ESRS.

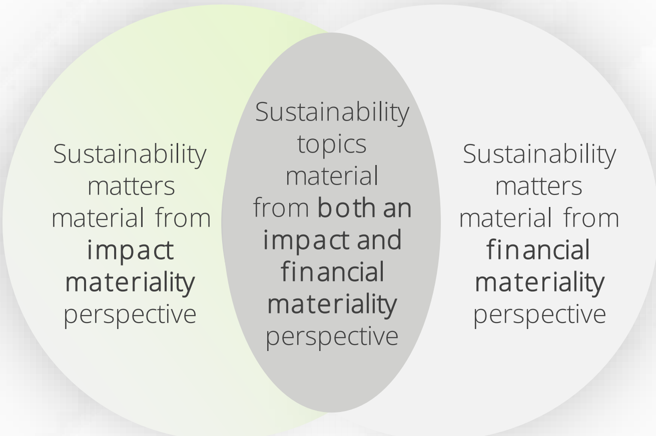
While both GRI and ESRS define materiality differently, the concept of materiality in both are effectively aligned.

Impact materiality
Significant impacts an organization has on the economy, environment or society or impacts which substantively influence the assessments and decisions of stakeholders. GRI indicates that the impacts of an organization are or will become financially material over time and they form the basis for financial materiality judgments.



The latest ESRS are drafted in such a way that the impact materiality perspective between GRI and ESRS are interoperable.

Double materiality
Significant impacts an organization has on the economy, environment or society, AND the impact that society and the environment have on the organization. Both should be applied in their own right without ignoring their interactions.



Materiality assessment

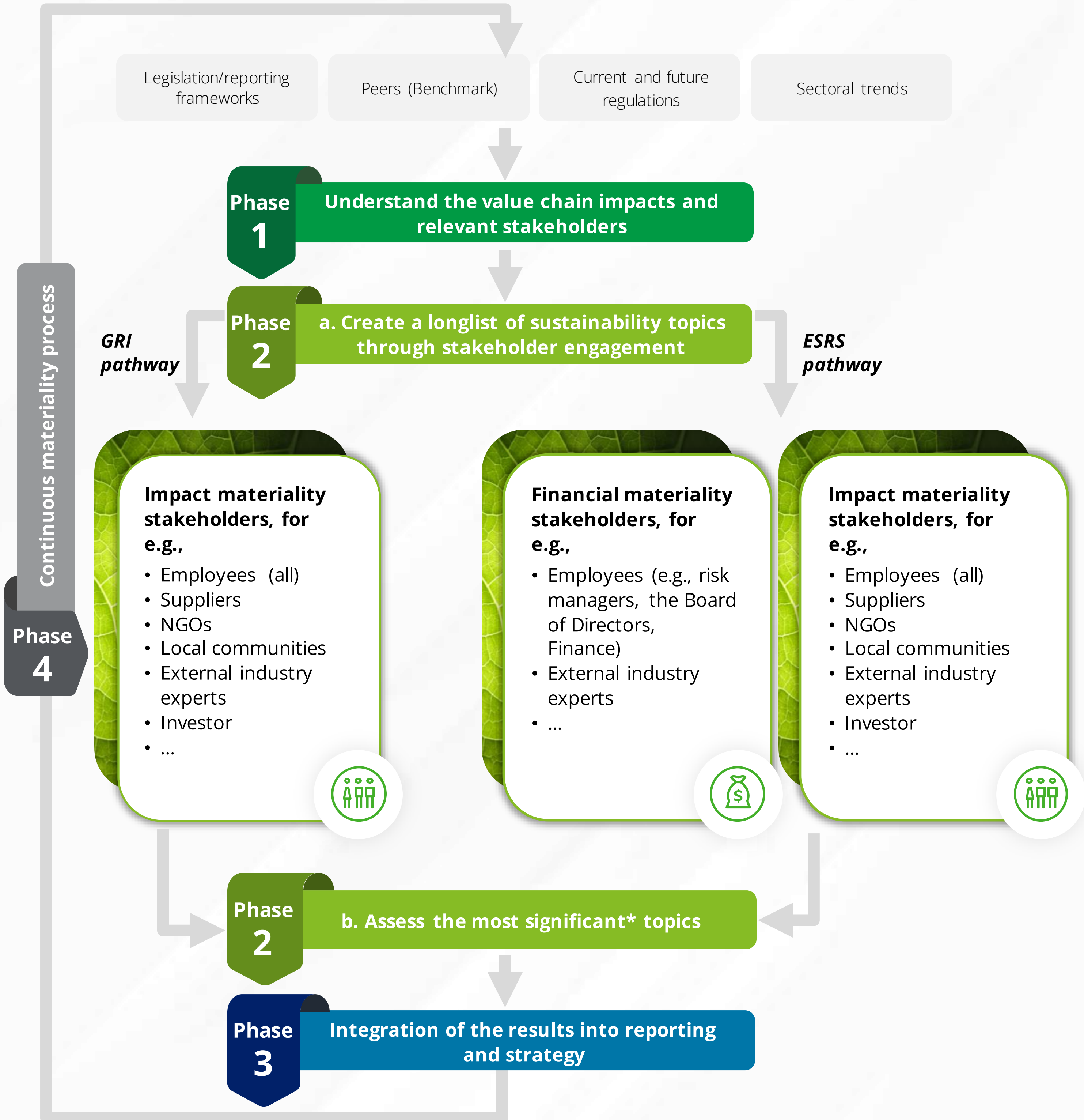
Interplay between the standards: GRI and ESRS

	Aspect	GRI	ESRS
Differences	**Focus:** Equal importance of impact materiality and financial materiality	Through focus on impact materiality, informing financial materiality	✓
Differences	**Geography**: Applicable to companies across the globe	✓	EU requirements with global implications
Differences	**Topic granularity**: The organization is encouraged to categorize levels of sustainability topics by subtopics and sub-sub-topics	Impacts can be grouped under more general topics	✓
Similarities	**Scope**: Assessment to be applied across full value chain	✓	✓
Similarities	**Sectoral specificity**: Materiality assessment should be conducted based on industry specifics	✓	✓
Similarities	**Stakeholder engagement:** The materiality assessment process should ensure that impact on all stakeholders is considered. However, no strict guidelines on stakeholder engagement are provided.	✓	✓

Materiality assessment

Deloitte's approach to materiality assessment

Although GRI and ESRS differ in terms of reporting requirements, both standards still have a significant overlap. At Deloitte we have designed a high level approach based on both. We have ensured that the approach can be tailored to your business needs, as illustrated in the diagram below:



*ESRS use the term 'material', which expresses the same as significant according to GRI

Materiality assessment

Deloitte's approach to materiality assessment

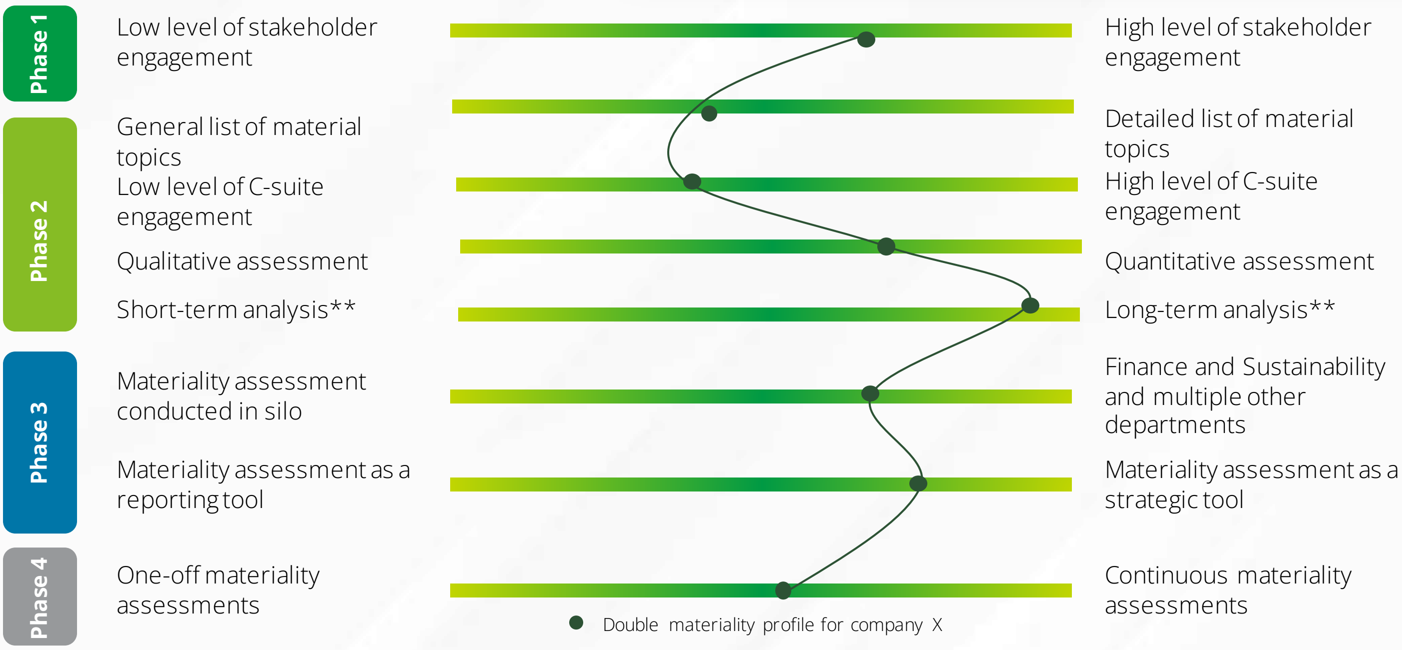
Before you start: Define your balance
A one-size fits all materiality assessment does not exist: tailoring is needed. One constraint could be budget and the time personnel have available. It is key to tailor the approach to fit both your own business needs and constraints, and your stakeholders' needs. We have defined a set of building blocks for each of the four phases. It is key to discuss them internally before you conduct your assessment.

Defining how you want to balance your approach is essential. Populating the framework below can be useful to align expectations upfront and can be done both with a selection of internal and external stakeholders. The diagram* below describes an illustrative example of a company following a balanced approach towards the materiality assessment.

Our view on the 'right' balance

Our view is that a materiality assessment requires balance:

- Spending too much time on engaging the CEO in the process is a waste of time and resources, while not involving the CEO at all could lead to stakeholders having a lack of trust in the outcomes of your process
- Interviewing thousands of stakeholders will not be helpful, as it is time-consuming and can lead to blurred results that lack concrete insights, while interviewing just a few stakeholders can lead to gaps
- Extensive quantitative analysis of each material topic can lead to a false sense of certainty, while downplaying the exercise to a pure qualitative assessment may lead to inaccurate/subjective scoring



Advantages

- Quick results
- Low cost and low efforts from internal employees

Advantages

- Balanced approach in terms of costs and outcomes

Advantages

- Potential to identify long-term risks and opportunities
- Enhanced stakeholder engagement

** Deloitte can assist further on chalking out an exhaustive set of design principles driving the materiality assessment that are fit-for-purpose.*
*** Both GRI and ESRS recommend long-term analysis. If the business opts for a short-term analysis for pragmatic reasons, it will have to disclose this explicitly to meet the standards*

Materiality assessment

Deloitte's approach to materiality assessment

Phase 1

Understand the value chain impacts and relevant stakeholders

- **Value chain and stakeholder selection:** Analyzing the impacts and relevant stakeholders across the company's value chain is important. Be sure to include a holistic group of stakeholders. Limited stakeholder engagement can lead to gaps. On the other hand, extensive stakeholder engagement may be lengthy and costly.
- **Granularity of material topics:** Striking the right granularity balance is important to ensure topics are not too generalized (e.g., climate change) or too detailed (e.g., $PM_{2.5}$ emissions). ESRS provide guidance on topics and its definitions. Defining each topic from a financial and impact lens is important to create a common understanding of each topic for stakeholders.

Phase 2

a. Create a longlist of sustainability topics through stakeholder engagement

- **Stakeholder engagement guiding principles:** Setting clear guiding principles to drive the materiality assessment will ensure a strong foundation to the process. This includes decisions on stakeholder engagement channel, the level and nature of participation in each channel, the stage in the assessment to involve certain stakeholder groups, how to test the results from stakeholder engagement, list of material topics, governance around the process and results visualization.
- **Scoring:** A robust scoring methodology needs to be in place, to ensure subjectivity is minimized. In addition, qualitative interview results can support the interpretation of the quantitative results. Traceability of assumptions is key to ensure readiness for external assurance (under CSRD limited assurance will be required in FY24 for companies falling under the NFRD and FY25 for all large organizations).
- **Time horizon:** The CSRD requires organizations to assess financial impact for the short, medium and long-term, as the financial impact of, e.g., climate change could increase over the years. Being transparent about the time horizon used is important.

Our view on quantification

In an ideal world, we see every matter being quantified both from an impact and financial materiality angle. Although tools are evolving, we see that most organizations are a long way away from achieving that. So, what can be done?

To assess the relative weighting of each matter, we see some leading organizations experiment with impact valuation techniques, converting each matter into a social cost or benefit to assess the impact perspective.

Furthermore, financial materiality can be assessed by integrated Net Present Value or risk models, including likelihood and severity. However, most organizations are still using proxies to determine severity and see how likely these are to occur in the future, e.g. historical share price fluctuations on events, change in expected regulations. We expect most organizations to report based on more qualitative assessments in the coming 2-3 years. In the longer term, when models become more advanced, more quantitative outcomes will be included.

The process is typically not linear and requires multiple iterations before outcomes are solid, as ideally multiple stakeholders are involved from a risk, finance and sustainability perspective.

Materiality assessment

Deloitte's approach to materiality assessment

Illustrative and fictitious example to show Deloitte's approach to 'double' materiality in practice
A large retailer with a global presence buying from producers in China, Bangladesh and India, wants to carry out an in-depth double materiality analysis in line with the ESRS requirements. To gain competitive advantage by becoming a responsible retailer, it wants to gain insight into the material sustainability topics that the business must focus on.

Among other sustainability topics in the ESRS, it focuses on the main topics (i.e., "matter" as per ESRS) 'Working conditions at suppliers' (the sub-sub-topic "forced labor"), given the rising concerns over human rights in supply chains in high-risk areas. Using Deloitte's approach as a guide, the business would conduct its materiality assessment **by addressing the below questions:**

Phase 2

b. Assess the most significant* topics

Impact materiality analysis:

I. What is the actual or potential positive or negative impact that a large retail business with global presence has on (forced) labor at suppliers?

Is there a possibility that forced labor occurs at suppliers of the retailer?
Given the characteristics of supply chain of the retailer and its own risk assessment, there is a potential for forced labor.

Does forced labor actually occur at the suppliers of the retailer?
At the moment, the retailer is not aware of the occurrence of forced labor at its suppliers.

Given the above, there is a potential negative impact that forced labor occurs at the suppliers of the retailer.

II. How material is the impact?

Determined by severity of the impact:
Scale
Forced labor in the supply chain is a serious matter, as any form of forced labor is a grave violation of human- and labor rights, which can affect both children and adults.
Scope
The retailer buys large amounts of goods from countries where forced labor may occur. Potentially, this involves many people in different countries, which could be adversely affected by forced labor.
Irremediability
The effects of forced labor can only partially be remediated, depending on the actual circumstances of the case.
Likelihood
The supply chain of the retailer extends to countries where forced labor occurs more often. Depending on the retailer's purchasing power, there is a greater likelihood that the negative impact will occur. On the other hand, appropriate mitigating due diligence measures taken by the retailer can reduce the likelihood of the occurrence of the potential negative impact.

Financial materiality analysis:

I. What (external) developments (triggers) are there with regards to forced labor at suppliers that could pose a risk (or opportunity) for the retailer?

The increasing attention from NGOs, regulations and awareness of consumers on the importance of human rights in the supply chain of companies and the prevention of abuses.

What is the risk of forced labor at suppliers that could have an actual or potential effect on the financial results and valuation (e.g., liabilities) in the future (on short, medium and long-term)?
- Short- and medium- term: Risk is that, in the worst scenario, business relationships must be terminated, the adverse effects for workers must be remediated and a switch must be made to another supplier with potentially higher labor costs. In addition, this could lead to a decrease in sales.
- Long-term: Risk is that, in case of large and/or multiple incidents of involvement in forced labor, the (commercial) reputational damage for the retailer. It also could lead to lawsuits requiring financial provisions.

II. How financially material is the risk (or opportunity)?

What is the likelihood that the risk (or opportunity) occurs?
It depends on the how reliant the retailer is on its high-risk suppliers. The supply chain of the retailer extends to countries with major country risk factors (such as governmental instability) and to countries where forced labor occurs more often. The retailers assesses that the likelihood of forced labor occurring – and related discontinuity of business and compliance issues - is high.

What is the financial effect if this risk (or opportunity) materializes?
The financial effect is potentially large and relates to higher purchasing costs as a result of a forced switch of supplier, litigation costs as a result of the obligation to remedy, and lower turnover as a result of delivery delays and departing consumers due to the retailers damaged reputation.

ESRS use the term 'material', which expresses the same as significant according to GRI

Materiality assessment

Deloitte’s approach to materiality assessment

Phase **3**

Integrating the results into reporting and strategy

- **C-suite engagement:** Carrying out materiality assessments requires top management to be involved. C-suite should be aware of the outcomes of the process and understand which topics are material from both an impact and a financial perspective. C-suite should also be involved in actively validating the outcome.
- **Cross-functional versus sustainability only:** As the financial effects of an organization's impacts are becoming clearer, involving multiple functions can bring clear benefits, such as providing a steering tool for management decisions, across the business.
- **Reporting versus strategic enabler:** Clearly define the objective of the materiality assessment, as a compliance driven approach differs significantly from using the materiality assessment as a strategic tool to assess risks and opportunities and to further develop or reshape a company’s ESG strategy. Determining the objective upfront with key stakeholders is crucial to success.

Phase **4**

Continuous materiality process

- **Frequency** of the materiality assessment differs significantly. We see frontrunners take a continuous approach, where the C-suite is involved to continuously capture valuable stakeholder insights.

Our view on integration

We believe it is key for the materiality process to not only be driven by the sustainability team.

Engaging other relevant internal departments, such as finance, internal risk management, procurement and HR brings clear benefits. In our view, risk management should be an integral part of the process and own the financial impact component.

It is crucial to ensure a clear governance and assignment of roles and responsibilities.

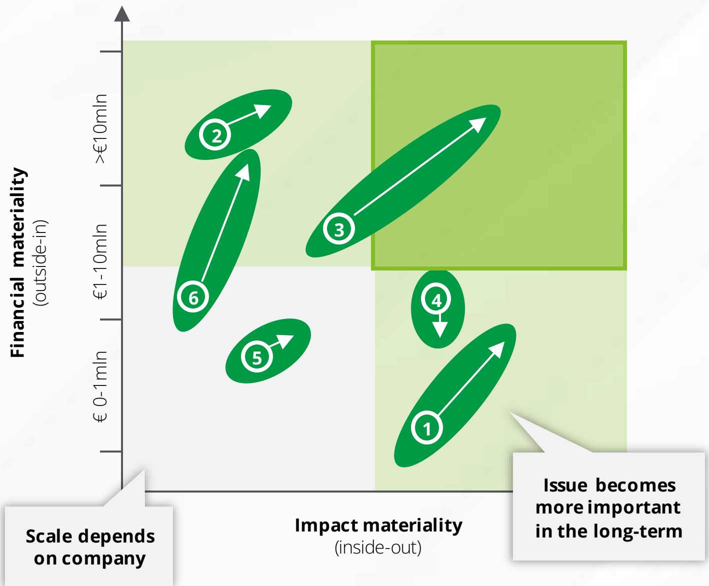
Materiality assessment

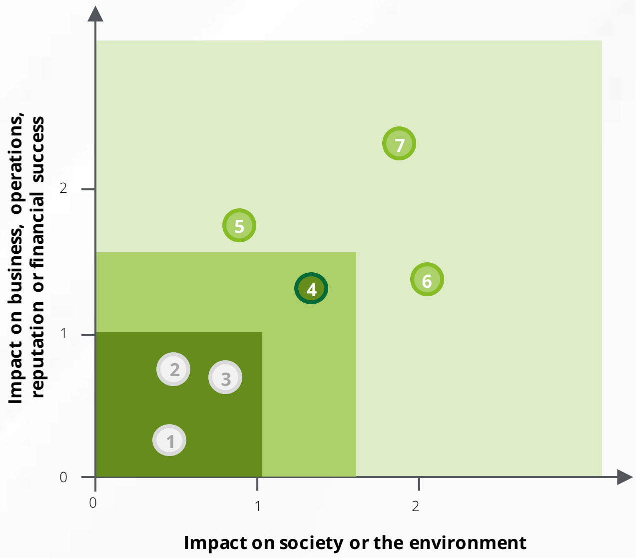
Deloitte's approach to materiality assessment

Neither GRI nor ESRS requirements prescribe how outcomes should be presented.

The figures below are examples of what outcomes could look like, in a double materiality matrix.

Double materiality analysis





Examples of potential material topics:

1 Water consumption
2 Human rights
3 Occupational health and safety
4 Waste management
5 Climate change
6 Biodiversity

Double material issues
Material issues
Low material issues
Importance of the topic in the long-term

1 Data privacy
2 Water
3 Biodiversity
4 Business ethics
5 Innovation
6 Energy storage
7 Renewable energy

Medium importance
Score of 0 – 1,0
High importance
Score of 1,0 – 1,5
Very high importance
Score of >1,5

The upper right quadrant contains topics that can be identified as material from both a financial and impact perspective. The secondary level of materiality falls into the zone of outside-inside and inside-outside analysis without crossover. ESRS indicate that these should also be considered as 'material' topics. In the example on the left, the changing nature of impacts over time is visualized as bubbles with arrows, representing the time span in which the impact is expected to occur.

Challenges & solutions: phase 1

First time or not, the materiality assessment process can be challenging especially now that the concept of materiality has evolved and has a financial lens **in addition to the traditional impact perspective**. In this section, we share the most common challenges we observe during discussions with our clients divided into three main themes: stakeholders, assessment and reporting & strategy.

How do you select the right stakeholders in the process?

When it comes to materiality assessments, defining right stakeholders is crucial because this helps organizations identify their impacts and apply related disclosure requirements correctly. However, depending on the size of a company the list of stakeholder groups can be long.

Solution

We recommend compiling a complete list of individuals and groups whose interests are affected or may be affected by the activities of the organization and engage with the defined groups. According to reviewed regulatory standards, the relevant stakeholders should be specified for each sustainability topic or sub-topic. You can collect the data not only throughout the materiality assessment, but also by regularly engaging stakeholders, using CRM tools, internal HR data, conferences, workshops, events and other means of communications, tailored for each group. To get your stakeholders to communicate their point of view (via stakeholder engagement channels), you should clarify to each group very explicitly about the purpose of the materiality assessment and the sustainability topics in plain, understandable language.

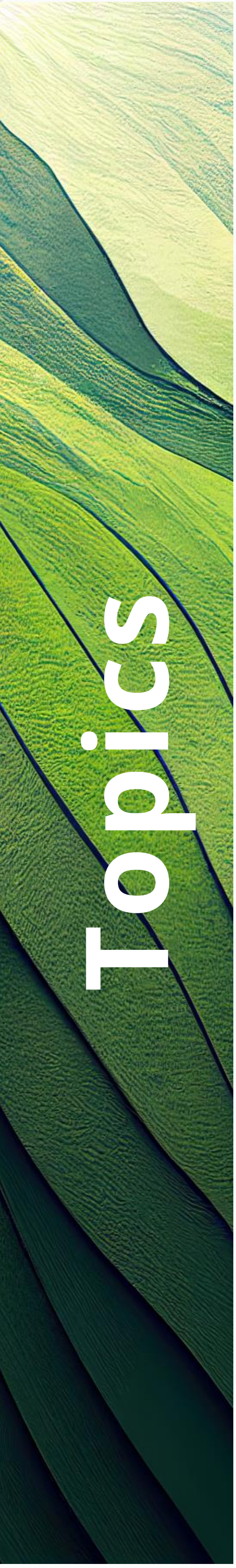
How can you engage the C-suite?

It can be tricky to get the C-suite involved in the materiality assessment process as it can sometimes be challenging to demonstrate the business value. So, organizations may face the problem of limiting the process to one group responsible for carrying out sustainability-related initiatives.

Solution

We recommend to clearly explain to members of your C-suite that a double materiality process now also includes the angle of financial materiality, showing the impact on the business in terms of risks, opportunities, costs and benefits, therefore illustrating the influence ESG issues have on the business. This can support top management in shaping a company's strategy. Starting the assessment from a risk or monetary perspective can help to engage with the CFO and CEO from the start. We also suggest for an individual board member to have ownership of the process and sign-off key milestones of the double materiality analysis (e.g., selection of the topics and definitions, validation of the stakeholder group).

Challenges & solutions: phase 1



What is the right granularity level for material* topics?

Businesses frequently struggle to define the right granularity level for material topics. It can be tempting to provide a general list of material topics for stakeholders' assessment that would fit every group. But it would lead to differences in understanding the significance of the topic and result in problems with evaluations and comparisons when identifying material sustainability issues for further reporting and management. Also, the difference in outcomes and impacts could result in uncertainty when defining materiality topics

Solution

When starting your assessment, first preparing a long list of potential material topics is key, after which grouping can take place. This will help you cluster interrelated impacts, such as energy efficiency, greenhouse gas emissions and climate change. We recommend to use impact pathways to cluster topics: showing the differences between inputs, outputs, outcomes and impacts. Stakeholder expectations can thus be managed, and this allows alignment of definitions and what is included or excluded for each topic. Once clustered, it is easier to conduct your materiality assessment and align the granularity level with your internal and external stakeholders. Furthermore, the level of external reporting of material topics can be different compared to using the assessment in internal decisions.

How do we weight issues in a robust way?

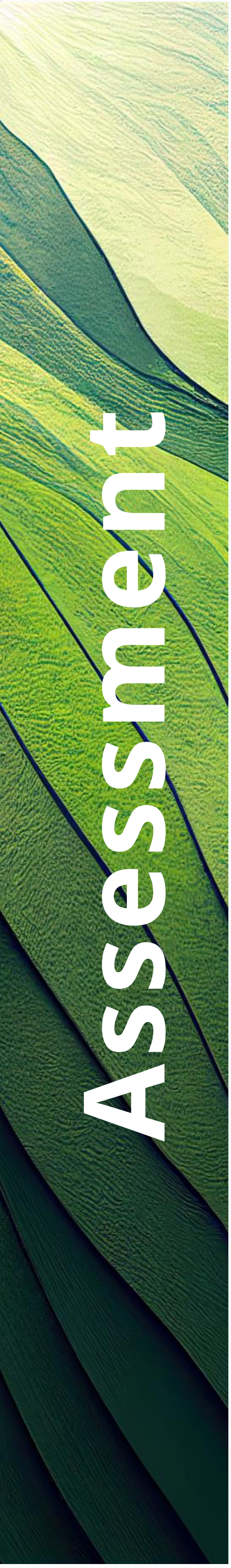
Businesses frequently struggle to make sense of the quantitative data obtained from surveys/interviews and other engagement processes. Often outcomes can be skewed towards employee opinions, because they usually form the largest response group. Similarly, NGO, local community and regulatory body viewpoints are typically under-represented and can be overlooked during the scoring process due to their small sample size compared to employees. The resulting risk is that the materiality outcomes are based on employee views, rather than on a balanced view from across stakeholder categories.

Solution

There is no perfect science to quantitative assessments of materiality outcomes. It is difficult to get the same levels of engagement across stakeholder groups, therefore a solution that helps to minimize the skewing of outcomes towards one particular stakeholder category's views, is to apply a weighted average across the results of each stakeholder group, therefore ensuring that each stakeholder group is allocated an equal weighting when considering overall scoring of outcomes.

**ESRS use the term 'material', which expresses the same as significant according to GRI*

Challenges & solutions: phase 2



How to define an appropriate time horizon?

Defining an appropriate time horizon requires taking into consideration industry-specific characteristics such as cash flow and business cycles, the expected duration of capital investments, the time horizons over which the users of sustainability statements conduct their assessments and the planning horizons typically used in the undertaking's industry for decision making.

Solution

Depending on the industry, size and type of business, the time horizon for risks can vary. For instance, the banking sector's mid-term period differs from the same period for the construction sector. We recommend to align your time horizons to:

1. Your investment horizons;
2. Your business model;
3. Your planning horizons.

After which you can use tools such as your internal risk management processes, and external international risk frameworks to incorporate these time horizons. If conducting a double materiality assessment for the first time, try not to focus on the whole value chain but try to apply a step-by-step approach, selecting a part of the value chain first.

How to assess the long-term risks if no data is available?

Robust sustainable risk assessment not only accounts for short- and medium-term risks, but also long-term risks. The inclusion of the latter is crucial as many environmental and social impacts have long-term consequences for either businesses or the society in which they operate. However, companies often face a lack of data for long-term risk analysis. Part of this is also due to the varying timeframes, depending on the industry, the region of operation.

Solution

A qualitative approach helps to identify the potential long-term risks and overcome the challenge of lack of historical data. The information gathered can serve as an initial step towards quantifying risks. As a follow up step, specific modeling tools and an understanding of the current impacts your organization already faces can help you in identifying the long-term risks that you may face and address them beforehand. Another step is to beware of key environmental, social and economic trends and risks occurring in the regions where you operate. According to the abovementioned World Economic Forum Global Risks Report 2022, the top-5 most critical risks that may occur in short-, medium- and long-term perspectives relate to environmental, social and economic aspects.

Challenges & solutions: phase 3

How do you integrate results into reporting and decision making?

It is essential for the company to assess outcomes of the materiality assessment against its strategy and business model. As a result, assessment results should be embedded into reporting and decision making. The methods on how to create awareness about materiality assessment results and integrate those into further decision making remains an open question.

Solution

The growing demand for transparency and accountability, greater stakeholder interest and the developing regulatory frameworks push companies into being more open on their impacts. Disclosing the ESG-related impacts in annual reports and/or sustainability reports in accordance with GRI Standards and/or ESRS requirements would build a better image of the company, increase trust and help the organization be a step ahead of their competitors.

Moreover, the double materiality assessment reveals ESG-related blind spots, which is essential for companies to consider when shaping their business strategy. The more data the management has on ESG, the more balanced their decisions will be.
Also, if a company consists of several businesses, it is important to prioritize the results individually for each business cluster.

How can you use a materiality analysis to move beyond compliance and use it as a strategic tool to identify risks and opportunities?

Many companies face difficulties in using materiality assessment beyond compliance. Although some of them see it as a tool to create strategic insights and value, it can be challenging to align materiality analysis with the process of identifying risks and opportunities especially when not all ESG risks are on your current radar.

Solution

The outcome of the materiality assessment can be used as a strategic tool, by reviewing it against a company's strategy and assessing its necessary strategic implications. The following elements can be helpful when identifying risks and opportunities:

1. Ensuring input is derived from multiple business functions, reviewed through a thorough screening process;
2. Although tooling exists to screen social media, it typically fails to find new risks or opportunities that you are not yet aware of, unless it can provide insights into 'hidden' risks in the deep web that suddenly become important;
3. Input from industry experts, either academic or business, providing insights into new (possibly disruptive) technologies or critical changes in political environments including change in government and legislation.

Identifying significant impacts on the economy, environment and society through a holistic approach enables the discovery of less visible issues in a timely manner, which on the longer run might turn into critical risks and financial consequences.

Contact list

Deloitte can bring understanding and expertise in this field of materiality assessment and support you in delivering a robust and impactful process.

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