Deloitte.

A practical approach to assess financial materiality

Working paper on double materiality

MAKING AN IMPACT THAT MATTERS since 1845

NOVEMBER 2023

Financial materiality

About this working paper

During a double materiality assessment, organizations need to assess both impact and financial materiality of sustainability matters. Whereas our *previous working paper* discussed the concept of double materiality, in this working paper we will focus on financial materiality. The aim of this working paper is to provide practical guidance for the financial materiality assessment of Environmental, Social and Governance (hereinafter: ESG) aspects, based on our project expertise, client experience and the draft guidelines of the European Sustainability Reporting Standard (hereinafter: ESRSs).

About this working paper

1. We present our interpretation of the ESRSs, acknowledging the evolving nature of ESG risks and opportunities (hereinafter: R&Os) during financial materiality assessments and the need for sector specific and business-specific considerations.
2. We discuss the practical implications of financial materiality, offering a perspective based on current leading practices.
3. We propose various methodological approaches and options for R&O based financial materiality assessments.
4. We discuss best practices for engaging with stakeholders during financial materiality assessments.
5. We provide guidance on turning ESG R&Os into actions and connecting the results of financial materiality assessments with broader enterprise risk management, strategy, budgeting and motivation processes.

Deloitte publications on double materiality

Previous working paper **|**
Balancing your materiality assessment

In this paper, we acknowledge the new nature 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 2022 draft standards.

CSRD Series |
Double materiality explained

Please find our webinar where we explore the practical implications of the CSRD requirements around double materiality. Through a series of questions with experts in our team, we aim to demystify some of the complexities of a double materiality process. Click on the image above to watch it.

Double materiality

Diving into financial materiality assessment

Why is it important to assess financial materiality of ESG R&Os?

ESG R&Os can have a range of positive or negative effects on a company's brand, reputation, operations, business continuity, financial outlook and long-term enterprise value.

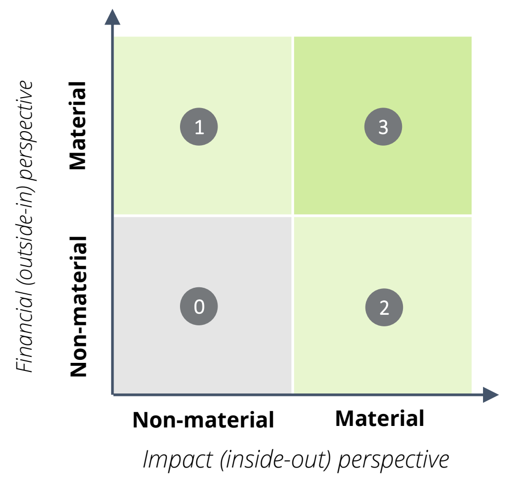
Understanding the financial materiality of sustainability matters is key to prioritizing and effectively addressing the associated R&Os. When these matters are managed effectively, they can be transformed into powerful opportunities for stakeholders, driving long-term strategic value.

The ESRSs require a robust process to identify R&Os related to sustainability matters in a rigorous and transparent manner that can withstand the scrutiny of auditors and external stakeholders.

Double materiality includes significant impacts that the organization has on the economy, environment and society *(impact perspective)*, and the financial effects that these matters have on the organization itself *(financial perspective)*.

These topics may overlap and, due to their potential impact on the firm's longer-term performance, are all important to consider when setting strategic objectives.

The ESRSs are transparent regarding the presentation format of financial assessment outcomes (an example can be seen on the right). In this document, we outline a range of methods for processing these findings.



Defining financial materiality

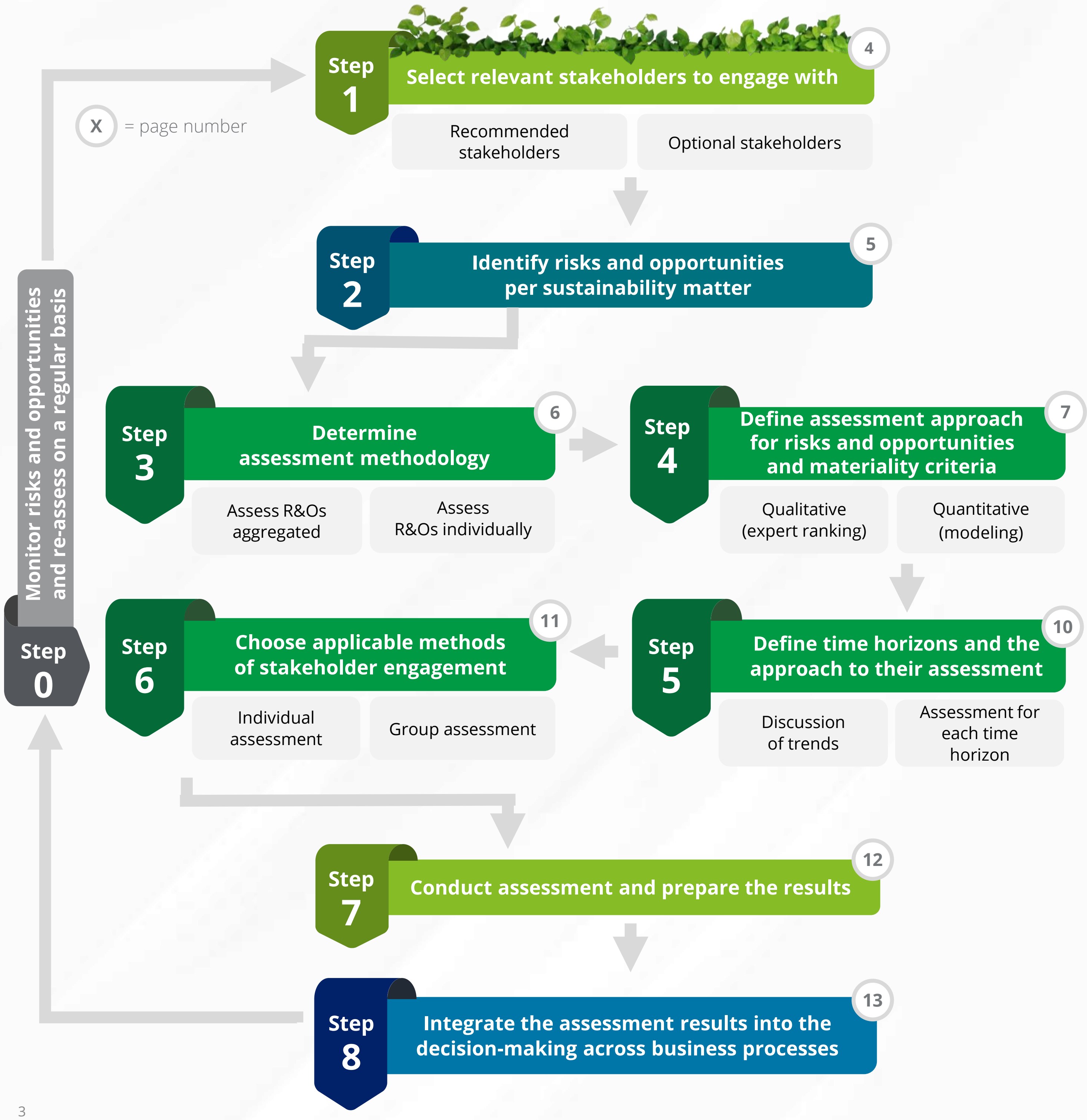
According to ESRS 1* on General Requirements: "A sustainability matter is material from a financial perspective if it triggers […] material financial effects on the undertaking. This is the case when a sustainability matter generates […] risks or opportunities that have a material influence […], on the undertaking's development, financial position, financial performance, cash flows, access to finance or cost of capital over the short-, medium- or long-term. Risks and opportunities may derive from past events or future events. The financial materiality of a sustainability matter is not constrained to matters that are within the control of the undertaking but includes information on material risks and opportunities attributable to business relationships with other undertakings or stakeholders beyond the scope of consolidation used in the preparation of financial statements."

* *ESRS 1, Annex C, paragraph 49 (https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set_en)*

Financial materiality assessment

Our approach

In order to assess the financial materiality of ESG R&Os, we have established a step-by-step approach aligned with ESRS' requirements. Considering the differences in companies' corporate structures, business models, enterprise risk management, and sustainability maturity, this guidance provides several methodologies and approaches for each step. Companies can choose or combine the methods that are most applicable to them. It is important to understand that the process below should be monitored and updated on an ongoing basis. Each step of the process will be comprehensively discussed in the remainder of this working paper.



Step 1

Select relevant stakeholders to engage with

Recommended stakeholders | Optional stakeholders

Throughout the process, the involvement of internal and (in some cases) external stakeholders is critical in the financial materiality assessment. In our previous working paper, we indicated the importance of selecting appropriate stakeholders to engage with when starting the double materiality assessment. During the financial materiality assessment, the stakeholders that are relevant to engage with are slightly different from those relevant to the impact materiality assessment. For financial materiality, it is essential to include stakeholders who:

- Are directly or indirectly involved in the company's risks and opportunities;
- Have insights into the business implications of ESG matters;
- Have insights into the financial matters related to the company and offer unique perspectives.

Key driving stakeholder groups

Recommended stakeholders to engage with

These types of stakeholders often have key insights needed to assess R&Os and can include external parties too. Incorporating these stakeholders creates a multi-dimensional assessment of financially material matters.

- **Strategy:** By engaging the strategy team, material issues are identified and assessed based on their alignment with the organization's strategic direction. This enhances the organization's ability to prioritize and address financially material issues.
- **Finance:** By involving the finance team, materiality is assessed in terms of potential financial risks, costs, and benefits. This financial lens adds depth to the assessment, facilitating informed decision-making.
- **Sustainability:** Involving the sustainability team helps to identify issues that resonate with the organization's sustainability commitments.
- **Enterprise risk management:** By incorporating ERM, a risk-centric perspective is incorporated into the assessment. This perspective ensures that material issues are evaluated not only for their opportunities but also for potential risks. This improves the organization's resilience and sustainability in the face of uncertainties.
- **Internal audit:** The audit team can provide comprehensive insights into the organization's sustainability-related processes.

We suggest having one representative from each business function to form a small project team. "Other relevant stakeholders" and company leadership can be involved as challengers or validators.

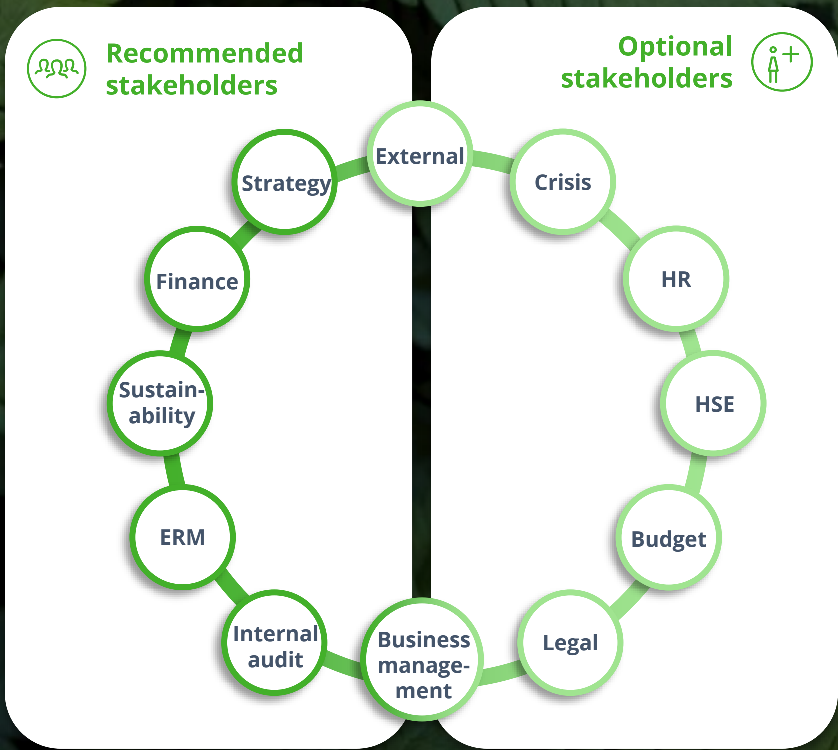
Other relevant stakeholders to consider

"Consulted when needed" stakeholder groups

Engaging these stakeholders is necessary when specific insights into sustainability matters from their perspective cannot be covered by key driving stakeholders.

Stakeholders such as the **Crisis team** are relevant in assessing financially material issues for their potential to escalate into crises. **Budgeting** is aligned with sustainability goals and risk management priorities. By including **Legal teams**, the assessment gains insights into the legal implications of sustainability matters, contributing to an understanding of potential legal risks. Stakeholders from **business management and other functions** can address business process risks and discuss the controls in place during the assessment.

Furthermore, the inclusion of **external stakeholders** (i.e., financiers, insurers) could provide outside, unforeseen perspectives on the R&Os of sustainability matters, that internal stakeholders may not provide.



Step 2 — Identify risks and opportunities per sustainability matter

After developing the long list of sustainability matters as the first step of DM *(see our previous working paper)*, the R&Os for each sustainability matter should be identified and their materiality ('significance') should be understood. In order to do this, the company should understand the ESRS requirements and consider industry specifics, business operations, and its enterprise risk management (ERM) process.

What are risks and opportunities?

Within ESRSs the term "risks and opportunities" refers to the undertaking's sustainability-related financial risks and opportunities, including those deriving from dependencies on natural, human and social resources, as identified through a financial materiality assessment.

** ESRS 1, 1.3 Drafting conventions 14 (https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set_en)*

How can organizations identify risks and opportunities

INTERNAL ANALYSIS

1. Value chain analysis: Analyze the company's business model, value chain and business operations to identify potential R&Os. See example below.
2. Past performance insights: Conduct retrospective analyses of previously identified R&Os for a comprehensive understanding.
3. Stakeholder engagement: Connect with stakeholders and business process owners to identify critical financial issues related to each sustainability matter.
4. ERM review: Deep dive into triggers to the corporate R&Os, as ERM considerations may also inform sustainability-related R&Os.
5. Sustainability matter breakdown: After identifying relevant sustainability issues, delve further into more detailed sustainability matters as potential R&O areas.

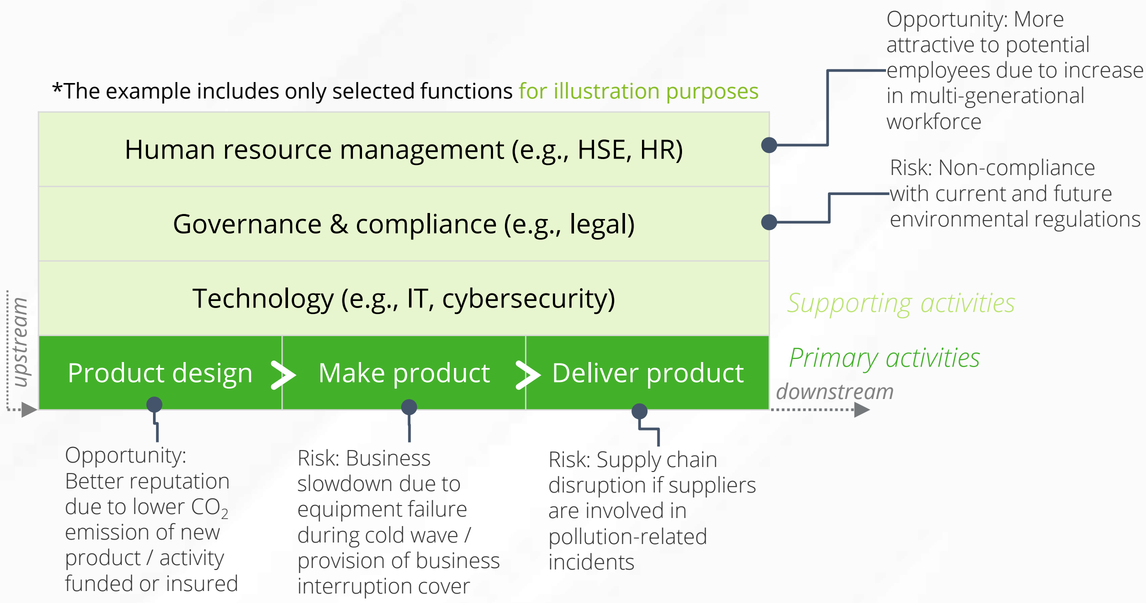
EXTERNAL ANALYSIS

1. Peer comparison: Investigate the R&Os identified by competitors during benchmarking exercises.
2. Trend and regulatory watch: Keep an eye on industry trends, regulatory shifts, political changes, and evolving social concerns to detect potential R&Os on the horizon.

*Example of value chain R&O identification (simplified)**

Start with mapping out the entire value chain, taking into account supporting and primary activities.

Then, identify potential R&Os related to the long list of sustainability matters.



Step 3

Determine assessment methodology

Assess R&Os aggregated | Assess R&Os individually

Depending on the maturity of the company's risk management, sustainability management, resources and the objectives of double materiality, the company can assess the financial materiality of sustainability matters at either a detailed (individual R&Os) or an aggregated level. Below we further discuss the two approaches that we primarily use.

Option 1
Assessment on aggregated level

Relevant risks and opportunities are discussed but not assessed on an individual level. Instead, the assessment is performed for risks (as one group), and also for the opportunities (as one group), related to a sustainability matter. Then, the sustainability matter is evaluated based on the R&O assessment results.

The discussion during the assessment is focused on topics, and corresponding groups of R&Os.

When to use: *Less complex approach for assessment, can be used when conducting a materiality assessment for the first time, risk assessment techniques are not yet well developed.*

Option 2
Assessment on individual level

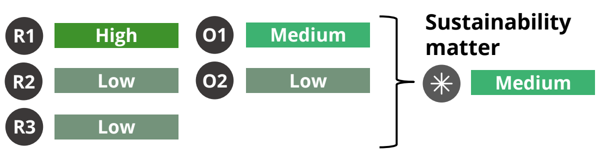
Risks and opportunities which are related to a sustainability matter, are identified and assessed individually. Then, the sustainability matter is evaluated based on the individual R&O assessment results.
Each R&O is individually discussed during the assessment. After that, sustainability matters are discussed based on the results from these individual R&O assessments.

When to use: *More in-depth assessment of the financial materiality, to be used when updating the existing materiality assessment and/or when the significant risks are already identified, and assessment techniques are utilized.*

Practical example:

Stakeholders provide assessment for a group of risks and a group of opportunities, without the assessment of individual R&Os. A list of individual R&Os can be used as supporting material. Based on the assessment results, the final sustainability matter score is determined.

Stakeholders provide assessment for each R&O. Based on the individual R&O assessment, the final score for a sustainability matter is determined.



Step 4

Define assessment approach for risks and opportunities and materiality criteria

Qualitative (expert ranking) | Quantitative (modeling)

The assessment of R&Os can be provided by qualitative assessment (expert ranking) and/or by quantitative modelling.

Before the R&O assessment, ensure that all stakeholders share a consistent understanding throughout the assessment process. Here are four key considerations stakeholders should take into account:

1) What is meant by R&Os:

- The potential losses/benefits of one risk event; or
- The potential annual losses /benefits; or
- Summarized losses/benefits for the whole time horizon.

2) What type of losses/benefits are assessed:

- Expected losses/benefits; or
- Unexpected losses/benefits; or
- Stress losses/benefits.

Incidental losses/benefits are often the starting point, as they are not budgeted and are more likely than stress ones.

3) What parameters are used:

Define the assessment scales, criteria, and thresholds for material sustainability matters.

4) What risk level is assessed:
Determine if the assessment is for inherent (without any controls) or residual (with applied controls) R&Os or both. Consider that (a) current/planned actions don't guarantee 100% risk elimination, and (b) material matters should be disclosed irrespective of the measures implemented. However, the R&O materiality assessment should not be purely theoretical; it should reflect the existing business context.

Expected losses/benefits

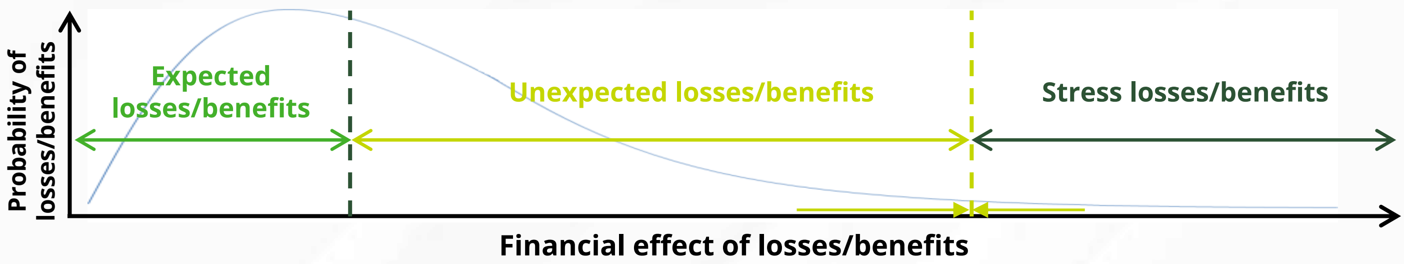
Periodic losses/benefits from R&Os, considered "normal" and are often budgeted.
Example: Due to regular seasonal storms, the company would have to budget EUR 400,000 for annual maintenance.

Unexpected losses/benefits

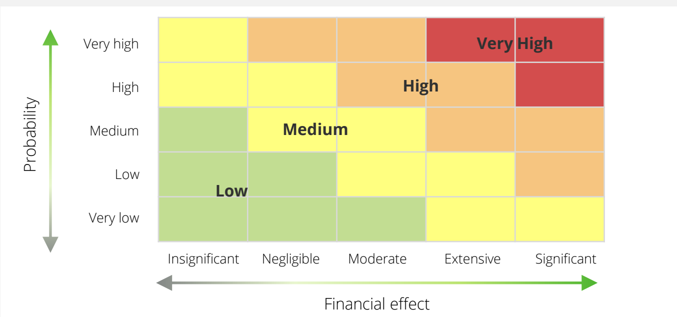
Incidental and unforeseen losses/benefits that occur beyond the expected ones.
Example: In the event of a superstorm, the company might incur an additional EUR 4 million in reconstruction.

Stress losses/benefits

Stress losses/benefits refer to events that could occur under extreme but plausible adverse conditions.
Example: In the case of rare flooding, the company's assets could be completely disrupted.



Example of scales for qualitative assessment of risks and opportunities



The probability/financial effect scale is the most used tool for R&O assessment.
The scales and axes can vary among different organizations. Using this scale, the user should assess the probability of an event based on the extent of financial effect.

Step 4 — Define assessment approach for risks and opportunities and materiality criteria (continued)

Qualitative (expert ranking) | Quantitative (modeling)

The qualitative (expert ranking) approach proves to be cost-effective, demanding less time and fewer resources. Additionally, it is simple and easy to understand, as this approach does not involve complex calculations. However, there are also some disadvantages: this approach involves relying on subjective judgment, utilizing expert insights and assumptions without statistical data and modelling. When defining scales, companies should ensure that the scales align with the ERM approach.

	Definition	Ranking	Criteria (example)
Financial effect scale	For R&Os identified, the financial consequences should be assessed in terms of losses/benefits. All non-financial losses/benefits can ultimately be assessed as financial ones.	1 Insignificant	**Loss/benefit that is estimated as:** A% or less of financial parameter
		2 Negligible	Between A% and B% of financial parameter
		3 Moderate	Between B% and C% of financial parameter
		4 Extensive	Between C% and D% of financial parameter
		5 Significant	D% or greater of financial parameter
		1 Insignificant 2 Negligible 3 Moderate 4 Extensive 5 Significant	**People**: Influence on employees, HSE aspects **Operations**: Influence on business operations **Reputation**: Influence on company's reputation and market position as well as value creation or destruction
Probability scale	Risk likelihood is the chance or probability of a risk event/probability benefit occurring during a **certain (defined)** time horizon.	1 Very low	Event may occur under similar circumstances
		2 Low	Event occasionally occurs under similar circumstances
		3 Medium	Event sometimes occurs under similar circumstances
		4 High	Event often occurs under similar circumstances
		5 Very High	Event frequently occurs under similar circumstances

Financial parameters and percentages of thresholds should be taken from ERM. If ERM scales are not available, financial parameters and percentages of thresholds can be discussed with finance, budgeting and/or strategy departments based on their approach for business planning and financial result analyses. **Examples of financial parameters:** EBITDA, Net profit, Revenue

Non-financial scales should also correlate with financial ones. However, for stakeholders, it is sometimes easier to assess consequences using a non-financial scale during the ranking.

Step 4

Define assessment approach for risks and opportunities and materiality criteria (continued)

Qualitative (expert ranking) | **Quantitative (modeling)**

The financial materiality assessment of R&Os can also be achieved through quantitative modelling. This method allows for results to be evaluated quantitatively in terms of effect on Net profit, EBITDA, etc. However, the process of quantification and modelling is proven to be complex and time-consuming, requiring a significant amount of statistical and business data.

> As companies enhance their ESG R&Os modelling capabilities, the quantitative modelling approach becomes more useful.
>
> While certain sustainability matters like climate risk take precedence in quantification, other key sustainability concerns – from nature to water – can be integrated over time.

Three-stage approach for quantitative financial materiality assessment

1 Model logic development

Analyze the business consequences from ESG R&Os and how they relate to financial parameters

2 Defining R&Os modelling parameters

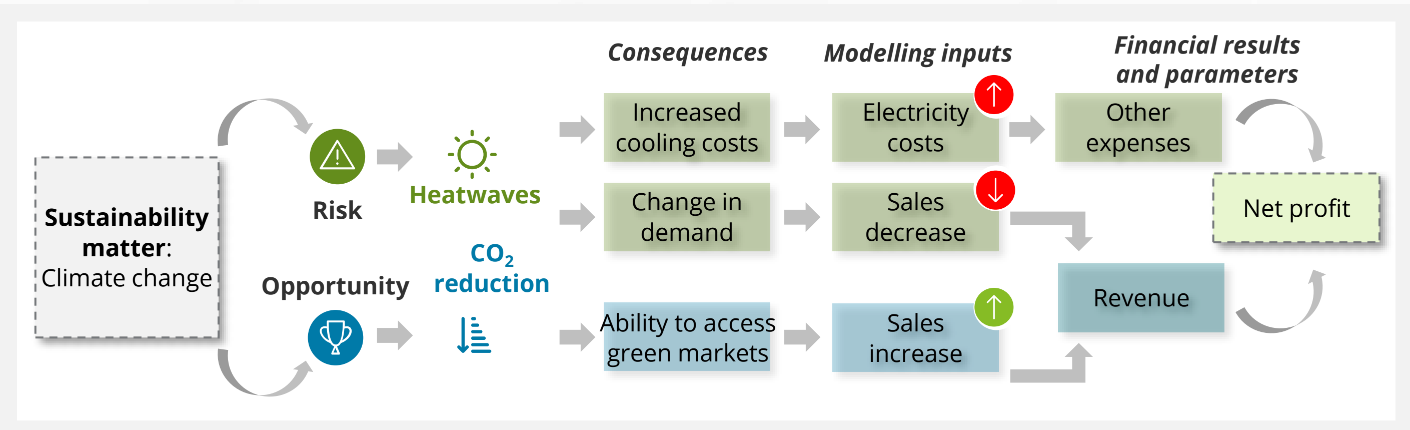
Collect statistical data and expert assumptions of R&Os parameters

3 Results preparation

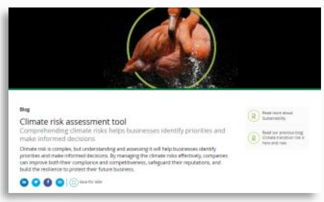
Model the influence of R&Os on financial results

Practical example (simplified)

Climate change can cause physical and transition R&Os → **...that can have both direct and indirect consequences...** → **...that influence financial results, cash flows and enterprise value**



Please find our article about risk scenario assessment for physical climate risks



Step 5

Define time horizons and the approach to their assessment

Discussion of trends | Assessment for each time horizon

R&Os should be assessed for three time horizons. Current best practice is to assess the financial materiality for each time horizon. Some organizations may assess the financial materiality for one time horizon and discuss the trend of financial materiality for others.

OPTION 1
DISCUSSION OF TRENDS

Assess the financial effect of R&Os for one specific time horizon (e.g., short- or medium-term). Then, analyze the trends for two other time horizons: evaluate the relevance of the R&Os and how its assessment results might change.

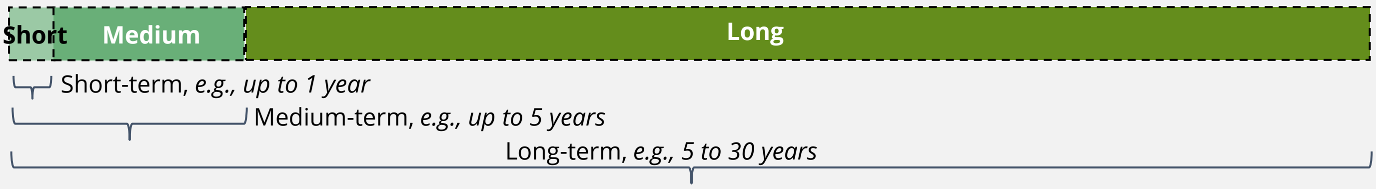
Application
Use this approach when conducting a materiality assessment for the first time, or when the risk assessment approach is less mature. During trend analyses, collaborating with the strategy team can be valuable to gain insights into the company's future plans from a strategic perspective.

OPTION 2
ASSESSMENT PER TIME HORIZON

Assess the financial effect of R&Os for each time horizon, ensuring that the financial materiality of each sustainability matter is evaluated across all horizons.

Application
Use this approach if your organization has already applied a more mature risk assessment or has already utilized all three time horizons for other assessments.

THREE TIME HORIZONS FOR ASSESSMENT (provided by ESRSs)



DISCUSSION OF TRENDS

Risk/ opportunity	Short-term score	Long-term score
R1	High	No change
R2	Medium	Increases
R3	Low	Increases
O1	High	Decreases
O2	Medium	No change

ASSESSMENT PER TIME HORIZON

Risk/ opportunity	Short-term score	Long-term score
R1	High	High
R2	Medium	High
R3	Low	Medium
O1	High	Low
O2	Medium	Medium

The definition of time horizons

According to ESRS 1* on General Requirements, "When preparing its sustainability statement, the undertaking shall adopt the following time intervals as of the end of the reporting period: (a) for the short-term time horizon: the period adopted by the undertaking as the reporting period in its financial statements; (b) for the medium-term time horizon: from the end of the short-term reporting period defined in (a) up to 5 years; and (c) for the long-term time horizon: more than 5 years."
ESRSs allow to use other time horizons that align with the company's specific circumstances, for example, strategy or budget planning.

* *ESRS 1, Definition of short-, medium- and long-term for reporting purposes, paragraph 77 (https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set_en)*

Step 6

Choose applicable methods of stakeholder engagement

Individual assessment | Group assessment

Due to the diverse and varying set of stakeholders a company interacts with on a regular basis, there is not a singular, universal approach to stakeholder engagement during R&O assessments. Below we introduce some recommended methods for engaging stakeholders.

Individual assessment

Questionnaire/self-assessment
A questionnaire is sent out to stakeholders to evaluate R&Os from a financial materiality perspective. A briefing meeting prior to sending the questionnaire would be of benefit, supplemented by pre-read materials to ensure a common understanding and alignment on expectations.

Stakeholder interview
During interview sessions, stakeholders are directly asked to assess each sustainability matter from a financial materiality perspective. This can be used to discuss risk consequences, assumptions for risk ranking/modelling, and collection of financial inputs.

Application
The approach is of value in situations in which in-depth information is needed on stakeholder views, and from those stakeholders who have sufficient knowledge of the company's financials and can assess financial effects.

Advantages
Allows thorough exploration based on individual expert knowledge

Disadvantages
Individual interviews and questionnaire preparation and briefing can be time-consuming

Group assessment

Stakeholder workshop
These sessions allow the development of a structured discussion. As ideas are being built on each other, new perspectives can unfold.

Step 1 Deep dive into the list of sustainability matters, including the R&Os associated with each matter.

Step 2 Utilize voting tools or other approaches to assess the financial materiality perspective of each stakeholder.

Step 3 Discuss the summarized outcomes and validate obtained assessment results.

Application
The approach enables a diverse set of stakeholders to jointly brainstorm and promptly validate outcomes.

Advantages
Can lead to new perspectives on financial consequences

Disadvantages
May gravitate towards conformity

Combination

We suggest to combine individual assessments with group discussions if this is feasible. Depending on the company's size and the number of topics and stakeholders, priorities can be set for individual or small group discussions.
In some cases, it can be beneficial to discuss R&Os alongside effects, especially when dealing with the same stakeholders. This approach can add extra value and streamline the process, saving time.

Interacting with stakeholders in-person is favorable, because it enables deeper communication, the ability to go deeper into a person's perspectives and substantiation thereof.

Step 7

Conduct assessment and prepare the results

Once the assessment of financial materiality is complete and the findings have been validated, your organization should determine the material sustainability matters and select the optimal method for showcasing the outcomes. The results of the R&O financial materiality assessments can be presented by utilizing various graphical approaches.

Presentation of results of financial materiality assessment in different time horizons

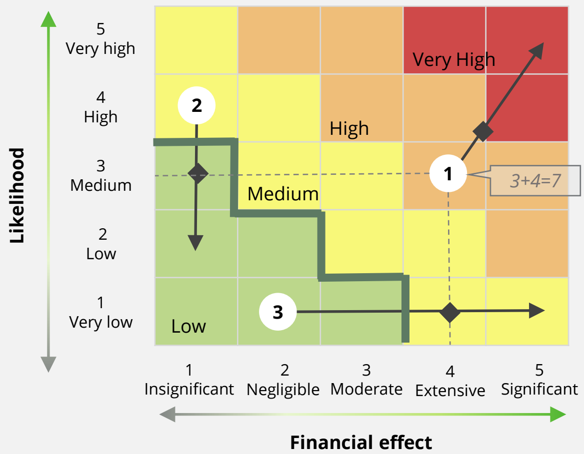
The examples below offer several methods for visualizing the results of R&O assessments and making decisions (defining the threshold) about material topics based on financial materiality. Companies should choose a threshold for materiality and determine the criteria for deeming a topic material (in line with company's ERM framework). For instance, a topic is already considered material if it falls under the threshold for at least one of the time horizons.

Example of sustainability matters, for which R&Os have been assessed:

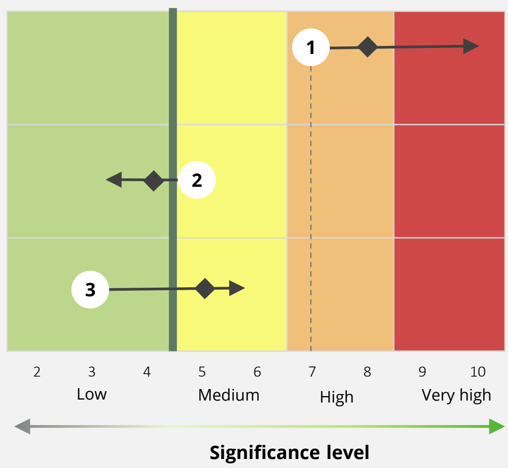
1 Climate resilience 2 Water pollution 3 Biodiversity

Materiality threshold Short-term Medium-term Long-term

Visualization example 1 "Heatmap"



Visualization example 2



The **heatmap** and **significance levels** (low, medium, high, and very high) should be in line with company's ERM framework.

Arrows indicate the trend of the matter across different time horizons based on the assessment.

Another option for visualizing the assessment results of each sustainability matter is to focus on the changes in overall **significance level** across different time horizons. This approach does not include details of the likelihood and financial effect scales.

The **significance level** is determined by combining the likelihood and financial effect.

For example, for Topic 1, 'Climate Resilience', the significance level can be determined by adding the likelihood score to the financial effect score: 3 (likelihood) + 4 (financial effect) = 7.

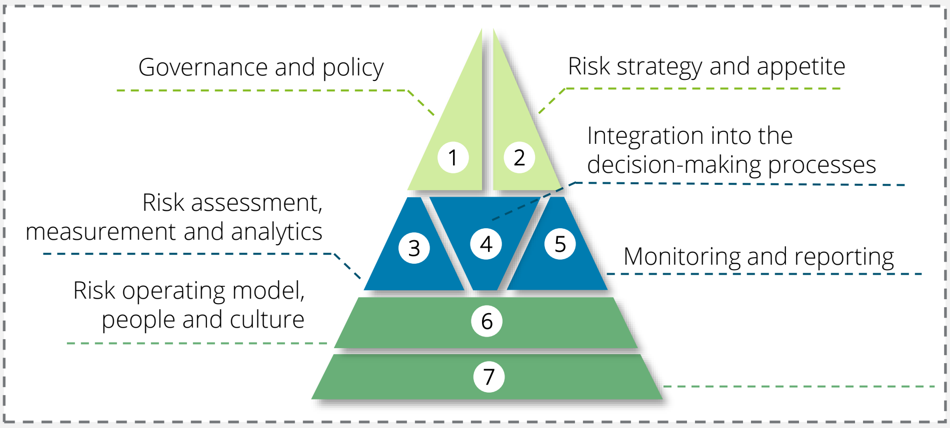
Step 8

Integrate the assessment results into the decision-making across business processes

The final part of the financial materiality assessment is to streamline its conclusions into the daily decision-making process of the organization, its business planning, budgeting, management, remuneration and the overall enterprise risk management (ERM) process. When done right, it unlocks powerful opportunities for the organization, generating value. We introduce a framework below which helps this integration through seven functional areas.

Key components to successfully integrate ESG R&Os into ERM

The integration should take a comprehensive approach, which cuts across different roles, functions and material topics in the organization. Following the components of the pyramid should facilitate the holistic evaluation of significant risks and identification of new market opportunities.



1 **Governance and policy**
Relevant risk owners should be mapped to efficiently cascade the ESG strategy through the organization. Clear roles and responsibilities, ESG risk taxonomy, escalation protocols, reporting and change management should be defined to manage ESG R&Os.

2 **Risk strategy and appetite**
ESG R&Os considerations should be embedded in the company's strategy (including its product offerings and business model, insurance strategy etc.). The current and future financial and non-financial effects from sustainability matters should be integrated in the company's risk appetite.

3 **Risk assessment, measurement and analytics**
A quantitative and qualitative approach should be established to identify, assess and prioritize ESG R&Os (e.g., climate scenario analysis). Capabilities and infrastructure should be available to conduct robust risk assessments, which should be aligned with the wider sustainability strategy.

4 **Integration into the decision-making processes**
The ESG R&Os assessment should provide a base to develop risk mitigation and adaptation actions, which includes an implementation plan for the most vulnerable assets. These measures should be an integral part of budgeting considerations.

5 **Monitoring and reporting**
Tools and metrics are necessary to monitor the company's exposure to financial ESG R&Os and eventually disclose those that are material both publicly and to regulators. Implementing processes and controls across three lines of defense addresses ESG regulatory commitments for managing ESG risks and enables the reporting of non-financial information.

6 **Risk operating model, people and culture**
Align the risk operating model with the sustainability strategy for lines of businesses, control environment, accountability, taxonomy and enterprise-wide tolerance levels. Consider establishing an ESG Advisory Committee to address ESG R&Os, and dedicated training programs and protocols for incentives and disciplinary actions.

7 **Risk data and systems**
Implement ESG data architecture and systems to track internal and external sources of ESG R&Os and integrate systems and data from applications operating across the enterprise for effective risk management.

Contact list

Vanessa Otto-Mentz
Partner
Sustainability
votto-mentz@deloitte.nl

Ivan Kukhnin
Partner
Sustainability
ikukhnin@deloitte.nl

Wim Bartels
Partner
Sustainability
wbartels@deloitte.nl

Priti Hoffmann
Partner
Sustainability
prhoffmann@deloitte.nl

Frits Klaver
Director
Sustainability
fklaver@deloitte.nl

Tatiana Budishevskaia
Director
Sustainability
tbudishevskaia@deloitte.nl

Han Hindriks
Director
Sustainability
hhindriks@deloitte.nl

Joep Rinkel
Senior Manager
Sustainability
jrinkel@deloitte.nl

Elizaveta Ustilovskaya
Senior Manager
Sustainability
elustilovskaya@deloitte.nl

Pip de Fonblanque
Senior Manager
Sustainability
pidefonblanque@deloitte.nl

Special contribution acknowledgement to Aleksandra Egorova in addition to the contacts for driving content creation.

Designed by CoRe Creative Services. RITM1576567