
1 February 2024

Dear EFRAG

Re: Draft EFRAG IG 1 Materiality Assessment

Thank you for the opportunity to offer comment on the materiality assessment implementation guidance (MAIG). We have been supporting large global corporations on materiality assessment and sustainability reporting for over a decade, and we were early adopters of the double materiality concept (dating back to EFRAG's February 2021 proposal for a sustainability reporting regime grounded in double materiality).

We also have deep expertise in corporate strategy, sustainability, and risk management. In particular, we are well-versed in navigating the many biases toward myopic, short-term thinking that lead to negative external impacts and poor long-term performance. Our suggestions below are founded on concern that the MAIG, as currently written, may inadvertently fall prey to these biases and not achieve its intended aims. We hope you consider these suggestions useful as you seek to implement a much-needed reporting regime that transforms global corporations to support a sustainable future.

1. Mitigating actions should not be considered when assessing potential (future) impacts

Paragraphs 215 and 218 of the MAIG are in conflict, and may result in results that do not reflect the intent of the materiality assessment process.

Paragraph 215 suggests that impacts should be considered before any mitigating actions in the materiality assessment. This is consistent with previous EFRAG guidance and other relevant standards such as GRI and UNGP. In contrast, paragraph 218 suggests that companies can consider the effect of mitigating actions when assessing potential impacts (subject to specific conditions about the actions such as their technical feasibility, economic viability, etc.).

For many potential environmental and social impacts, such as pollution and health/safety, companies will have mature management actions that reduce the actual impact to near zero. If companies are permitted to take these management actions into account when assessing potential impact over the short, medium, and long term, there is a good chance that the companies will rate the potential impact as very low across all time frames. Unless the organization sets a "very low" materiality threshold (which is unlikely because it would end up capturing nearly every possible sustainability matter), the potential impact related to "mature" issues such as pollution and health/safety would be deemed not material for reporting.

This result would not meet the intent of the materiality assessment process. If a business model involves pollution or dangerous activity, it is material for stakeholders to understand the company's approach to managing these considerations. If a company is permitted to take its approach into account when assessing the materiality of impacts for reporting, information on the company's pollution or health/safety policies, action plans, metrics, etc. would not be included because pollution and health/safety impacts would be deemed immaterial (per the example in Figure 1). Such an omission would run against the intent of the ESRS/CSRD.

Figure 1. Permitting companies to consider mitigating actions when assessing potential impact may result in an outcome/disclosure that does not reflect the impacts inherent to the business model.

	ACTUAL IMPACT ASSESSMENT	POTENTIAL IMPACT ASSESSMENT				
Company impacts	Current period (this year)	Short-term (within 1 year)	Medium term (within 5 years)	Long term (5+ years)	Materiality determination	Disclosure result
Pollution impact	Very Low	Very Low	Very Low	Very Low	Very Low actual/potential impact NOT MATERIAL FOR REPORTING	E2 Pollution NOT included in Sustainability Statement.
Health and safety impact	Very Low	Very Low	Very Low	Very Low	Very Low actual/potential impact NOT MATERIAL FOR REPORTING	S1 Own workforce (health and safety) NOT included in Sustainability Statement.

Companies should be asked to consider potential impacts before **any** mitigating actions, no matter how mature/feasible/viable, so that the materiality assessment remains true to the company's business model. If the mitigating actions are successful, this would be reflected in the assessment of actual impact within the reporting period (as stated in paragraph 217). It may be the case that businesses always rates many potential impacts as high, and then rate the same actual impacts as low/none. This would be a sign of a good business that identifies potential impacts, takes action to mitigate them, and discloses performance (Figure 2).

Figure 2. Requiring companies to consider potential impact before the implementation of any mitigating actions ensures the inclusion of material impacts in the disclosure. The success of mitigating actions is reflected in the low actual impact during the reporting period.

	ACTUAL IMPACT ASSESSMENT	POTENTIAL IMPACT ASSESSMENT				
Company impacts	Current period (this year)	Short-term (within 1 year)	Medium term (within 5 years)	Long term (5+ years)	Materiality determination	Disclosure result
Pollution impact	Low	High	High	High	High potential impact MATERIAL FOR REPORTING	E2 Pollution included in Sustainability Statement. Company must disclose its pollution-related policies, action plans, targets, and annual performance.
Health and safety impact	Low	Very High	Very High	Very High	Very High potential impact MATERIAL FOR REPORTING	S1 Own workforce (health and safety) included in Sustainability Statement. Company must disclose its health/safety-related policies, action plans, targets, and annual performance.

The only way a company should be able to assess a reduced potential impact into the future would be if there is an upcoming change to its business model. For example, if there are potential environmental and health/safety impacts from hazardous materials, but the business has entered into an agreement to sell the hazardous materials component of its business in two years, this would enable the business to reduce the severity of potential impact (from the medium term onward) because of changes to the business model and not because of mitigating actions (Figure 3).

Figure 3. A company that uses hazardous materials enters into an agreement to sell the hazardous materials component of its business in two years. This would reduce the environmental and health/safety potential impacts into the future because there is a change to the underlying business model.

	POTENTIAL IMPACT ASSESSMENT		
Company impacts	Short-term (within 1 year)	Medium term (within 5 years)	Long term (5+ years)
Environmental impact from hazardous materials	High	Low	Low
Health and safety impact from hazardous materials	Very High	Low	Low

Related suggestion: Allow companies to factor mitigating actions into the determination of anticipated financial effects

In many cases, environmental and social impacts will give rise to financial risks, and companies may be required to disclose the anticipated financial effects of these risks. As explained above, ensuring that potential impacts and risks are assessed prior to any mitigating actions will ensure that the company is required to include these impacts and risks in the report when material for the business model.

For material financial risks, companies may be required to disclose the anticipated financial effects of these risks. If a company has a mature management approach to the potential impact/risk, then a requirement to determine anticipated financial effects would result in an awkward situation where the company has to disclose a hypothetical financial consequence of management failure at some point in the short, medium, and long term. If a company already has a technically feasible and economically viable approach, it makes more sense for them to disclose the expenditure associated with this approach as part of its action plan (capex/opex) and then – because they have disclosed a viable and economically feasible action plan – **not** be required to estimate anticipated financial effects associated with the risk (Figure 4).

In contrast, if a company does not have a feasible/viable approach, then it would not be able to demonstrate that it has a reasonable action plan and thus would be expected to disclose anticipated financial effects from the risk (Figure 4). This forces the company to “put the money where its mouth is” and disclose either committed capex/opex or anticipated financial effects for its material financial risks.

Figure 4. Companies with technically feasible, economically viable management approaches should not be expected to disclose anticipated financial effects, because they will be able to disclose mature action plans supported by capex/opex.		
Financial risk example	Action plan (capex/opex)? (e.g. ESRS 2 paragraphs 68-69)	Anticipated financial effects? (e.g. ESRS 2 paragraph 48(e))
Environmental risk with mature approach (e.g. wastewater pollution)	Company's mature action plan and associated capex/opex are disclosed.	Company would not be expected to quantify anticipated financial effects, because it has disclosed a mature action plan supported by capex/opex.
Environmental risk without an approach (e.g. GHG emissions with vague emissions reduction target)	Company is unable to articulate a technically viable, economically feasible action plan. No capex/opex disclosed.	Company would be expected to quantify anticipated financial effects, because it was unable to disclose a viable, feasible action plan.

2. Provide greater clarity on non-monetary thresholds that may be used to determine financial materiality

When setting thresholds for financial materiality, paragraph 123 seems to suggest a preference for monetary thresholds, whereas paragraph 126 suggests that non-monetary thresholds (such as reputational risk) may be suitable. Paragraph 125 suggests that qualitative “factors” may be suitable for thresholds where financial effects cannot be reliably measured. We agree with the need to be flexible and be sure that the thresholds reflect the circumstances of the financial risks/opportunities in question. At the same time, these materiality assessments are being performed within a corporate environment with a strong bias toward quantification and monetization that may leave some risks or opportunities deprioritized because they cannot be monetized reliably (even though they may be material per ESRS definition). It may also be hard for a reader of the guidance to distinguish between monetary vs non-monetary, quantitative vs qualitative, absolute vs relative, and so on.

We ask that EFRAG offer greater clarity as to examples of permitted thresholds across monetary, non-monetary, and qualitative factors (Figure 5 offers a range of such thresholds), EFRAG may wish to clarify that factors such as reputation, customer preferences, and exposure to regulation (among others) may be used as proxies for monetary impact (Figure 6 describes how non-monetary thresholds can serve as useful proxies for financial effects – using examples of customer and regulation proxies).

We also ask that EFRAG state that there is no preference for one type of threshold (monetary/non-monetary/qualitative) over another. We recognize the importance of objectivity and rigor in these assessments, but equating quantification with objectivity/rigor may lead organizations down a biased path. Many efforts to quantify future financial effects are not rigorous and would not meet the reporting principle of verifiability. We have witnessed many important sustainability matters deprioritized by companies because their effects could not be monetized with confidence. In contrast, we have witnessed transparent, verifiable, and rigorous exercises of prioritization using qualitative thresholds and relative rankings. Although these efforts have not sought to quantify every financial effect, they have established a consensus within the organization and among investors on the sustainability matters that overlap most significantly with the business model and thus could reasonably affect financial performance. Based on our read of the standard, it seems that it is better to have a transparent, verifiable, and repeatable approach that meets the qualitative characteristics of useful information than an approach that preferences monetization and lays prone to black box quantification methods and known biases.¹

We believe the following quote reflects EFRAG’s intent, but which may not be met if EFRAG is perceived to prefer monetary thresholds: “Many entities’ interactions with ESG issues do not yet have an easily measurable impact on market value or the price of products, materials, or cash flows. For some ESG-related risks, this can be addressed by including a non-financial measure directly in the prioritization criteria. For example, some organizations prioritize risks that lead to any significant safety incidents as “high” regardless of whether a financial impact can be quantified.”²

Figure 5. Examples of threshold metrics across monetary, non-monetary, and qualitative factors.³

Measure	Example risk severity metrics
Quantitative (monetary)	Revenue: Projected or identified impact on revenue or expenditures Expenditures: Projected or identified impact on expenditures or costs EBITDA: Projected or identified impact on EBITDA Assets and liabilities: Write-off, asset impairment and early retirement of existing assets Capital and financing: Impact to cost of capital or access to capital, operating losses Share price: Impact (%) in share price ^c Customer/reputation: Reduction in customer confidence (%) (may also be measured in revenue) Safety: Lost time due to injuries
Quantitative (non-monetary)	Social media coverage: Number of viewers of the entity’s video Business continuity: Maximum allowable outage Greenhouse gas emissions: Total emissions by type of greenhouse gas (GHG); carbon intensity (GHG/USD \$ million) Energy/fuel: Total energy consumption in megawatt hours Water: Total freshwater withdrawn in cubic meters from water-stressed regions Land use: Percentage change in land cover type (e.g., grassland, forest, cultivated, pasture, urban) Location: Number of locations within a designated flood zone Capital and financing: Increase or decrease in ability to raise capital Reputation: Type of complaints received from stakeholders ^d Staff morale/turnover: Engagement survey results/level of engagement
Qualitative	

¹ Our concern is limited to quantification of forward-looking assessments (anticipated/potential effects). In contrast, current effects should be quantifiable in many circumstances because the event giving rise to the effect has already occurred.

² COSO & WBCSD (2018) Enterprise Risk Management: Applying enterprise risk management to environmental, social and governance-related risks, page 53

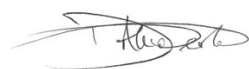
³ COSO & WBCSD (2018) Enterprise Risk Management: Applying enterprise risk management to environmental, social and governance-related risks, page 53

Figure 6. Examples of thresholds for customer and regulation effects that serve as proxies for financial effects. ⁴ At EFRAG's request, we can provide our thinking on regulatory, natural resource, and reputation proxies.		
Magnitude rating	Examples of proxies (quantitative)	Examples of proxies (qualitative)
Critical	Customer proxy: Threatened or actual loss of []% strategic customers Human capital proxy: More than []% employee turnover	Customer proxy: Threatened or actual loss of enough customers to concern the viability of the business. Human capital proxy: Inability to access the talent and capabilities required to execute the strategy and business model
High	Customer proxy: Threatened or actual loss of []% strategic customers Human capital proxy: Results from employee survey showing staff morale more than []% less than peer organizations	Customer proxy: Threatened or actual loss of enough customers to merit a significant shift in corporate strategy Human capital proxy: Significant concern over the capacity to attract the right talent and capabilities, or retain/sustain an engaged workforce that can execute the strategy and business model - requires active management to resolve
Medium	Customer proxy: Threatened or actual loss of []% strategic customers Human capital proxy: Results from employee survey showing morale []% less than peer organizations	Customer proxy: Threatened or actual loss of customers that would require some strategic change, or temporary challenge Human capital proxy: Challenge with access to talent and capabilities that affects a contained aspect of the business, or a generalized challenge that is temporary. Any response is specific to the location or temporary.
Low	Customer proxy: Threatened or actual loss of []% strategic customers Human capital proxy: Individual feedback from employees on low staff morale	Customer proxy: Threatened or actual loss of customers in excess of annual variability, but not enough to merit strategic change Human capital proxy: Effect on talent attraction and retention that is outside normal variability but not sustained or widespread enough to merit a response.

Paragraph 124 states that companies “shall consider financial effects associated with dependencies on natural and social resources that do not meet (or do not yet meet) the criteria for accounting recognition.” This is excellent guidance to ensure that these range of resources are factored into the assessment. However, because these resources have been omitted from financial accounting for so long, trying to quantify or monetize their “materiality” will leave the assessment prone to the biases that have plagued natural and social resource management for decades. Offering greater clarity as to permitted qualitative, non-monetary thresholds (as suggested above), will offer comfort to practitioners seeking to meet the assessment aims of appropriately considering the importance of non-financial resources.

We commend EFRAG's efforts in establishing the ESRS and associated guidance. Thank you for the opportunity to provide feedback on the materiality assessment implementation guidance. We hope that the feedback is useful and that you can see how our suggestions are meant to ensure the process achieves its intended result. If you have any questions or would like to discuss any aspect of our feedback, please feel free to get in touch with me on +1 646 465 0967 or alex@bwdstrategic.com.

Kind regards,



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⁴ These proxies are adapted from COSO & WBCSD (2018) Enterprise Risk Management: Applying enterprise risk management to environmental, social and governance-related risks, page 49