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Materiality for ESG: Science or Art?

Task Force for Climate Change Related Financial Disclosures[1] (TCFD) published "Proposed Guidance on Climate Related Metrics, Targets and Transition Plans" in June 2021. TCFD invited topics on many topics, including **materiality.**

Many believe materiality is a formula – a complicated formula, but a science nonetheless. DHC suggests that materiality is part science and part art. Here is a summary of DHC's comments to TCFD. For more insights on materiality of Environmental, Social and Governance (ESG) issues, contact us at info@douglashileman.com.

1. **Traditional "Materiality" doesn't quite fit climate change related disclosures.** The traditional approach to materiality is not well-suited to climate change related disclosures. SASB[2]'s rigorous process for identifying material ESG topics did not result in climate change being material for all industries. With climate change as arguably the ESG issue of single greatest impact and interest to investors, climate change disclosures should be required for all filers.

2. **Materiality is in the eye of the beholder.** Traditional materiality focuses only on the company. It considers revenues, profitability, and objective and subjective factors. It involves professional judgment. The basis for materiality is not disclosed in external assurance reports; users are left to trust the judgment of those making the statements.

3. **Materiality is subjective.** ISAE 3000 indicates that "Professional Judgment is necessary in particular regarding decisions about materiality[3]…" This professional judgment is exercised by an external

Materiality is punitive to small companies. Traditional materiality is inherently punitive on smaller companies, or companies in low-margin sectors. The same climate change related risk posing $100 million impact poses different materiality to a large cap company with $1 billion in net income, than it would to another company in a razor-thin profit sector (for example, a grocery retailer) with net income of $5 million. Smaller companies bear the brunt of compliance and administrative burden, while organizations with enviable profitability or massive size can avoid disclosures, hidden behind the veil of materiality.

[1] See www.fsb-tcfd.org
[2] Sustainability Accounting Standards Board; Note that SASB merged with another organization to become the Value Reporting Foundation in 2021.
[3] International Standard on Assurance Engagements; ISAE 3000 (Revised); Assurance Engagements Other than Audits or Review of Historical Financial Information; Final Pronouncement December 2013; published by International Auditing and Assurance Standards Board; paragraph A.81, p. 43.

assurance provider (also limited to external assurance provided by a Certified Public Accountant)[4]. Disclosures are not necessarily subject to external [financial] assurance; as such, materiality is at the discretion of the organization.

4. **Double materiality isn't ready for its close-up.** One thought leadership piece referred to the concept that businesses should report on financially material topics that influence enterprise [financial] value, as well as topics material to the economy, the environment and people. In other words, double materiality expands beyond the traditional "inside out" approach to determining materiality and embraces an "outside in" approach where external stakeholders can make this determination. Another write-up interpreted double materiality as consideration of an organization's size and contribution to relevant metrics, such that the traditional materiality threshold and judgments would not provide the same opportunities for large, profitable organizations to refrain from disclosures. Double materiality is still too new and not yet universally understood – by reporting organizations, internal governance functions, Internal Audit, external assurance providers, analysts or investors – to include at this time.

Commenter suggests simply requiring climate change related disclosures of all organizations, except those that can demonstrate non-applicability using "double de minimis" criteria.

Douglas Hileman Consulting LLC (DHC) supports Clients in environmental, social and governance (ESG, or "Sustainability"), audits/ risk/ compliance, and non-financial reporting (aka "Sustainability reporting"). See also www.douglashileman.com.

[4] Commenter is not a CPA. Commenter has supported external financial assurance engagements as an ESG/ environmental specialist. Commenter has conducted external assurance engagements ("Independent Private Sector Audits") pursuant to the U.S. SEC Conflict Minerals Rule as a non-CPA auditor, according to performance audit standards of Generally Accepted Government Audit Standards.