Business owners and materiality, part 3: What is "double materiality" and does it matter?

Executives & Entrepreneurs

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- The concept of materiality can help business owners pinpoint, measure, and manage the most relevant data for their firm. Materiality also matters for customers, stakeholders, and investors.
- The "double materiality" approach considers that sustainability trends have two broad types of influence on a company and society. On one hand, companies are affected by sustainability issues. On the other, companies drive sustainability effects that consumers, society, employees, and investors increasingly care about.
- We identified three potential implications of double materiality for founders, their firms, and their performance—both in commercial and sustainability terms:

1. The most material sustainability factors to society may not necessarily match those that drive financial performance
2. Double materiality may increasingly attract financial investors
3. Impact materiality may become core to doing business, not a consequence of it


Source: Getty Images

Private business owners and entrepreneurs know that having timely, decision-useful data is vital to the growth and performance of their business. Too much data can drain time and resources, which is why it's crucial to identify what matters most.

The concept of materiality can help business owners pinpoint, measure, and manage the most relevant data for their firm. Materiality also matters for customers, stakeholders, and investors.

In the first of this three-part series, we considered materiality and why it matters today, particularly as its definition increasingly extends to cover sustainability metrics around environmental, social, and corporate governance (ESG) performance.

In the second part, we explored sustainability materiality by examining how ESG factors in the outside world can affect an entrepreneur's business.

And in this third and final part of the series, we'll explore how sustainability materiality is increasingly focused on so-called "double materiality," investigate why entrepreneurs may have to pay closer attention to their firm's impact on the wider world, and suggest how business owners can make an impact in the most financially efficient way.

What is "double materiality"?

The "double materiality" approach considers that sustainability trends have two broad types of influence on a company and society. On one hand, companies are affected by sustainability issues. On the other, companies drive sustainability effects that consumers, society, employees, and investors increasingly care about.

Fig 1: Companies affect and are affected by sustainability issues

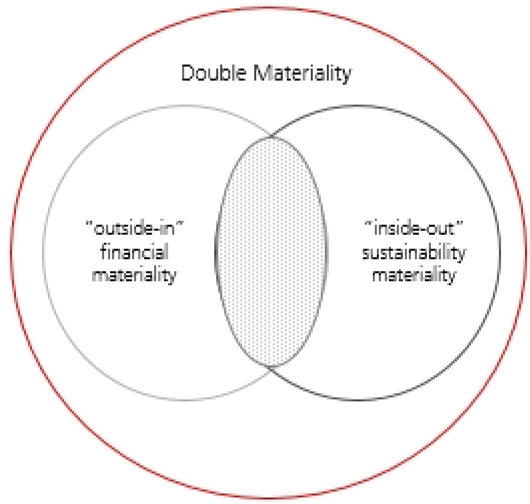
Source: UBS, 2022.

"Outside-in" sustainability materiality is one side of double materiality. As discussed in part 2 of this series, this describes how companies assess the sustainability factors *outside their control* that have the biggest effect on *financial performance.* This approach is analogous to investors that integrate ESG factors into their investment process.

The other part of double materiality is "inside-out" sustainability materiality. This direction of materiality describes how companies identify the sustainability factors arising from operating activities *inside their firm* that have the biggest *environmental, social, and financial consequences* on the outside world. This approach is analogous to investors that adopt social and environmental impact principles into their investment process.

Financial and sustainability materiality overlap in the area where business impact on the world is directly relevant to its financial performance. For example, a company manufacturing fabrics made from recycled material has a positive environmental impact, which directly relates to its ability to grow as a business.

Fig. 2: Double materiality includes both sustainability and financial materiality



Source: UBS, 2022

How does it affect the business?

Business owners may need to widen their analysis, data collection, and reporting capabilities if double materiality becomes a more widespread way to look at sustainability.

Double materiality goes beyond the outside-in approach to sustainability materiality—it's a main focus of financial risk management tools. It also aims to capture the positive and negative social and environmental impact of a business on the world at large.

Entrepreneurs may also have to consider their firms' role in supporting global environmental and social initiatives, such as the achievement of the United Nations' Sustainable Development Goals.

Although not universally accepted across all regions, the inside-out aspect of double materiality—or impact materiality—aims to capture the social and economic role that a business plays in its community and for a wide group of stakeholders beyond financially focused investors.

Business owners may need to watch closely how efforts to define and refine sustainability reporting standards develop and report in the way that best meets regulatory and stakeholder needs.

Currently, there are two broad approaches to materiality and its reporting.

The European Sustainability Reporting Standards (developed by the European Financial Reporting Advisory Group and Global Reporting Initiative) aim for double materiality reporting for an audience of multiple stakeholders. The Global Reporting Initiative, a voluntary standards-reporting initiative, provides guidance for company disclosures on double materiality.

The US and Chinese regulators have proposed reporting requirements that would focus on financial materiality only. Common standards on how to disclose sustainability-related financial data are also being drafted by the International Sustainability Standards Board (ISSB) for an investor-only audience and with an exclusive focus on financial materiality.

What does double materiality mean for founders, their firms' profits, *and* sustainability?

While double materiality has yet to become a mandatory requirement for all private businesses, we believe entrepreneurs (especially those operating internationally) need to understand the consequences of double materiality and the potential impacts on their financials, operations, and relationships.

Here are three potential implications of double materiality:

1. The most material sustainability factors to society may not necessarily match those that drive financial performance

In our report Three steps to becoming more sustainable… and profitable, we focused on how entrepreneurs can build processes to identify the environmental, social, and corporate governance factors that have the biggest influence on their firms' financials and enterprise value. We also discussed the importance of gathering stakeholder feedback on which sustainability topics matter, then using founder or manager discretion to focus efforts on the issues that drive commercial performance.

However, for business owners seeking to become impact businesses—ones that deliver measurable and verifiable positive and social impact alongside competitive financial returns—a materiality assessment may be more complex.

The chief reason for additional complexity is that the most material "outside-in" sustainability factors influencing financial performance may not match one-for-one with the most material "inside-out" environmental and social impacts of doing business. Nevertheless, some are likely to overlap depending on the industry.

Consider a business owner working in the food manufacturing industry. They may judge that the most important outside sustainability factors for their financial performance are water scarcity and the impact of climate change on crop availability/quantity. However, an impact materiality assessment may show that the company's most significant sustainability issue (in terms of environment impact) is its level of food waste across harvesting, production, and distribution.

What if tackling the most material inside-out factor—food waste—has the biggest effect on reducing negative environmental impact (carbon dioxide and methane emissions, for example) but has very little impact on the firm's cost of goods sold in the near term (for example, raw materials costs are dwarfed by labor costs and there are little or no commercial opportunities to repurpose this food waste as a component in the "circular economy")?

Business owners with no interest or stakeholder demand to become an impact business may decide solely to focus on the sustainability factors that drive short-term commercial performance. However, sustainability is not static. Entrepreneurs should therefore consider whether factors that are not material today may become so over time—both as potential risks and opportunities to financial and impact performance.

Other entrepreneurs looking to become impact businesses may need to broaden the number of stakeholders they survey. They may also benefit from gathering advice or best practices from others—whether trusted advisors, networks of other private business owners, or networks of social entrepreneurs with experience in double materiality assessments.

2. Double materiality may increasingly attract financial investors

In our research paper Three ways sustainability transparency can affect your business exit, we noted that regulatory changes (led by the European Union) are becoming ever more important for the private equity industry and other large asset owners. Financial investors looking at private companies for their sustainable funds may require potential portfolio companies to disclose on a double materiality basis.

This is because the EU's Sustainable Finance Disclosure Regulation (SFDR) will require sustainable funds, from 1 January 2023, to characterize themselves either as Article 8 funds (those that promote environmental or social characteristics) or Article 9 funds (those with an explicit sustainable or impact investment objective).

For example, private companies that are well-established and looking to raise funding from private equity may be required to report their company's positive or negative social impact on the EU Taxonomy's six environmental objectives: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, and protection of healthy ecosystems.

Not all private business owners will want—or necessarily need—to position themselves as impact companies or to garner interest from asset owners subject to the SFDR. But for business owners to keep their financing or exit options open, it may make sense to carry out double materiality assessments at an early stage, so the necessary materials are available for a potential buyer's or funder's due diligence.

Furthermore, the direction of travel for double materiality regulation may also require business owners exploring potential exit or acquisition options to engage with ESG and impact advisory experts, alongside their traditional corporate finance or M&A advisory partners.

3. Impact materiality may become core to doing business, not a consequence of it

If private business owners are required to report on double materiality—or voluntarily want to become social impact businesses that report their contribution to society at large—it is worth reiterating some of the defining characteristics of impact:

- **Founders or early-stage business owners should include "additionality," or adding new value where it would not have occurred absent the company, as part of their market analysis:** Start-ups are accustomed to describing the problem or challenge that their offering attempts to solve, frequently translating this into an estimated financial opportunity (market size). Impact calculations and estimations should feature in this market analysis—but true impact is additional. Put simply, founders should try to identify the measurable and verifiable environmental and social impact their product will aim to deliver *that would not otherwise have been delivered without their business.* Gathering this data would likely require acumen and deep expertise of the sustainability challenges and solutions already existing in a particular country, industry, or sector. Founders may find these insights via peer-to-peer business owner networks, connections to social entrepreneurs, or insights from impact philanthropists.
- **Impact generation should be intentional and not accidental to the regular course of business:** Founders that want to become social impact businesses should clearly articulate how their operating models aim to target competitive financial and impact returns in tandem, as opposed to just targeting commercial returns and measuring any "accidental" positive impact that is a consequence of doing business.
- **Founders with little time and money may benefit from a slimmed-down double materiality assessment that targets fewer sustainability factors well:** True impact should be measurable, backed by quantitative data that is verifiable and readily available for scrutiny—ideally by a qualified independent third party. But true impact can be both labor-intensive and costly for fledgling founders. In a world of fast-moving sustainability regulation that still lacks harmonized global standards, it may make sense for founders that want to run a profitable social impact business to keep their materiality assessment simple, learn as they go, and build flexible processes that can scale as their business does.

Conclusion

In this third and final part of a series on sustainability materiality, we explored "double materiality."

The "double materiality" approach considers that sustainability trends have two broad types of influence on a company and society. On the one hand, companies are affected by sustainability issues. On the other, companies drive sustainability effects that consumers, society, employees, and investors increasingly care about.

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Appendix

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