Appendix: Background research - Approach to financial materiality

1 This paper is a contribution of two EFRAG Task-Force participants performed in August 2021. It does not reflect the official positions of EFRAG and is attached as background research.

Objective

2 The purpose of this Appendix is to approach financial materiality for sustainability reporting, starting from the disclosures that derive from financial reporting and enterprise value creation and then defining sustainability financial related disclosures as the ones encompassing financial related sustainability information that are not captured, or not captured yet, by financial reporting. The underlying objective is to foster a seamless and more comprehensive financial related corporate reporting, combining financial reporting per se and financial related sustainability reporting.

3 This Appendix presents the approach to financial materiality to be used in sustainability standard setting; the intended user of this Appendix is the standard setter and not the reporting entity. This Appendix supports the identification of what the standard setter should require to be reported, i.e. to be mandatorily included in the report.

4 The process for assessing by the reporting entity which material risks and opportunities will have to be included in the report will be covered by the cross-cutting standard ESRS 4 *Sustainability material impacts, risks and opportunities*. This Appendix may also (indirectly) assist the reporting entity in providing a contextual background to the exercise of judgement requested when running its own materiality assessment. This is a secondary purpose of this Appendix.

Background

5 With a double materiality perspective, when looking at the financial materiality, the sustainability standard setter shall identify the possible ESG risks and opportunities (in neutral terms: factors) that are financially material, i.e. may positively or negatively affect the reporting entity's development, performance and position (over the short, medium or long term) and, therefore, create or erode its enterprise value.

6 In addition, the CSRD proposal puts an emphasis on intangible elements: Undertakings shall also disclose information on intangibles, including information on intellectual, human, social and relationship capital. This dimension is a key component of financial materiality.

7 Enterprise value is defined - *Reference: Reporting on enterprise value Illustrated with a prototype climate-related financial disclosure standard (December 2020)* - as market capitalisation (shareholder value) plus the market value of net debt. It is determined by capital market participants, based on their estimation, of the present value of expected cash flows, spanning the short-, medium, and long-term. Essential inputs in determining enterprise value include corporate reporting in financial statements and in sustainability-related financial disclosures. The term was deliberately chosen because it is widely used and is technically specific in capturing the notion of expected value creation over time for the company's equity and debt investors (which is emphasised to be distinct from, but fundamentally interdependent with, value creation/erosion for the company's other stakeholders).

The accounting and financial reporting fundamental concepts

8 **This section describes the key concepts underpinning financial reporting recognition.**

9 Financial accounting and reporting are based upon conceptual frameworks which guide the recognition of assets and liabilities as well as, in parallel, the recognition of revenues and costs ("double entry" system). This can be illustrated for instance by the non-binding Conceptual Framework of the IASB as well as by the underlying concepts of the EU Accounting Directive.

10 Recognition for financial accounting and reporting purposes implies that the following well established criteria are met:

(a) Assets have to be identifiable and under the control of the reporting entity as a consequence of past events. They are directly related to existing cash balances (or equivalent) of the reporting entity or future cash inflows for the reporting entity deriving from the control of other forms of assets. For example:

(i) Customer balances represent commitments received from third parties (customers) to pay cash amounts due to the reporting entity against the delivery of goods or services by the reporting entity in past periods. Customer balances are legally enforceable.

(ii) Inventories represent capitalised costs that have been incurred by the reporting entity in past periods to acquire, transform and assemble resources necessary to produce goods or services that will generate revenues and the related cash inflows through sales in future periods. Inventory items are owned by the entity, the transfer of ownership to customers takes place at the time of the sale.

(iii) Fixed assets represent capitalised costs that have been incurred by the reporting entity in past periods to acquire or produce resources that will be used in order to produce goods and services over several production cycles. Fixed assets are under the control of the reporting entity and generate future benefits.

(b) Liabilities have to correspond to commitments (obligations) from the reporting entity vis-à-vis third parties deriving from past events. They are directly related to existing cash debts (or equivalent) of the reporting entity or future cash outflows for the reporting entity. For example:

(i) Supplier balances represent commitments made vis-à-vis third parties (suppliers) to pay cash amounts due by the reporting entity against goods and services received in past periods. Suppliers have a legal claim against the entity.

(ii) Provisions correspond to existing or likely obligations for the reporting entity to incur in future period cash outflows the precise amount of which has to be estimated by the reporting entity.

(c) Liabilities are considered for recognition by way of provisions when the related outflows are more likely than not.

11 Once recognised on the basis of past events (retrospective approach) the measurement of assets and liabilities may have to take into account forward looking information related to the use or recoverability of recognised assets or to the extinguishment of recognised liabilities. Forward looking information is used to confirm or modify the initially recorded amounts, estimates are particularly important for the measurement of long term assets or liabilities:

(a) Assets must be impaired when it is likely that the expected cash inflows do not justify the amount recorded in the balance sheet. An impairment is recorded when it becomes likely that the full amount of the recognised asset will not be recovered, i.e. will not generate cash inflows at least equivalent to the recorded amount. As long as the asset is generating positive net cash inflows over and above the balance sheet carrying amount, no impairment is necessary. As a consequence the mere variation of the expected net cash inflows is not considered for financial accounting and reporting purposes as long as it remains equivalent to or greater than the carrying balance sheet amount (in comparison).

(b) Beyond the likelihood of the related obligation, provisions may need to be re-estimated on the basis of forward looking information, i.e. the expected evolution of facts and circumstances leading to the extinguishment of the liability. By contrast with the approach followed for impairment analyses re-estimating the related cash outflows has a direct impact on future cash flows: a modification of the balance sheet carrying amount is necessary as soon as the expected cash outflows differ from the ones previously estimated.

12 Financial profit is defined as the difference between recognised revenues and costs which is equal to the variation of the difference between recognised assets and recognised liabilities ('net assets').

13 The concept of control is also critical to define the operations that the reporting entity shall report upon under a consolidated approach. Only those entities that are controlled by the reporting entity are included in the scope, others forms of relationships are not directly considered as an integral part of the group managed by the reporting entity.

14 Finally, all the above apply under the umbrella of a so called ‘mixed model’ which combines, mostly on an activity by activity basis, the historical cost convention (for most non-financial activities and certain financial activities) and the fair value convention (principally for financial activities). Both conventions have advantages and disadvantages in terms of relevance. However for those activities reported upon under the historical cost convention this leads to take into account losses as soon as they are likely and gains only when they are realised. This is often described as the concept of prudence which promotes a conservative depiction of the reporting entity’s position and performance.

The informative qualities and clear borders of financial reporting

15 **Financial Reporting, either derived from IFRS Standards or from the Accounting Directive, is characterised by rules about recognition (and measurement) that guide the elements (assets, liabilities, income and expenses) to be included in the primary financial statements or reported in the notes. Those rules limit the possibility of including supplementary elements that are needed to assess the reporting entity’s enterprise value creation.**

16 The principles followed for the recognition of assets, liabilities, costs and revenues for financial accounting and reporting purposes put a strong emphasis upon three key dimensions of the financial position and performance of the reporting entity:

(a) A focus on separability, control and likelihood,

(b) For items measured on the basis of cost, a focus on prudence, and

(c) A focus on past positions and performance.

17 This emphasis creates a relatively high degree of informative quality about past cash inflows and outflows and future cash inflows and outflows deriving from past events (the unwinding of the position described in the balance sheet). This is one of the major interests of the financial accounting and reporting system put in place over decades and a robust basis for the understanding of reporting entity’s situation and evolution.

18 Any initiative to move away from those dimensions at financial standard-setting level should be considered carefully in order to avoid blurring the well understood significance of financial reporting:

(a) Financial reporting has reached a stage of stability and acceptance which is a key asset. Conceptual evolutions are potentially destabilising. The possibility of extending the recognition of assets beyond what is identifiable and controlled by the reporting entity or of extending the recognition of liabilities beyond what is the consequence of a commitment for the reporting entity or to expand the use of fair value has been envisaged. However this has finally been ruled out by the IASB and the European legislator. It would indeed increase uncertainty and create a gap between what is reported and the critical understanding of cash flows.

(b) The consequences of the above concepts in terms of informative quality of financial reporting may indeed give rise to disclosures in the notes to the financial statements which to a certain extent foster a better understanding of the position and performance of the reporting entity (for instance on unrealised gains). However, there is a limit to this exercise: too many disclosures may blur the basic goals of financial reporting by creating confusion on the fundamental meaning of financial statements.

(c) Progress in the informative quality of financial reporting should be considered primarily from a connectivity with sustainability reporting perspective through the provision of clear “anchor points” (in the notes) creating a seamless informative track with sustainability reporting (going both ways).

19 The counterpart of this relatively high degree of informative quality about key cash flows is the consequential existence of three clear borders of financial reporting.

20 The first border excludes from financial reporting facts and circumstances that have not reached the stage of being “more likely than not” for financial accounting and reporting purposes:

(a) On the asset side, any decrease in expected profitability derived from an asset will in principle not be captured by the financial statements as long as the profitability remains positive. It means that risks on the business model of the reporting entity triggering a decline in profitability will only be considered when the decline is such that the asset becomes loss-making. Before a loss-making situation becomes likely there are many stages of potential decline in profitability that can exist and which are not considered in spite of the fact that this is a highly valuable information from a financial perspective.

(b) On the liability side, any risk that is not the consequence of a past event or that, being related to a past event, does not represent a « more likely than not » commitment for the reporting entity shall be ignored. In business situations there are many circumstances where the risk cannot be excluded but has remote probability to materialise, or its probability or quantitative impact is difficult to assess. For example free (or cheap) access to natural capital does not create a liability for the reporting entity, whatever the related economic or social cost can be, since there is no (or only limited) cash outflow.

21 The second border excludes from financial reporting (i) factors of value creation that are not separable and/or under the control of the reporting entity, both in terms of existence and positive and negative evolution, as well as (ii) the potential upside (related to opportunities) of recognised assets (as compared to the balance sheet carrying recorded on a cost basis).

22 On the unrecorded factors of value creation:

(a) Many internally created intangible assets are key 'capitals' of the reporting undertaking. For example: human capital, relationship capital, organisational capital, intellectual capital… They often represent the major part of the enterprise value, well over and above the net assets of the reporting entity as established through financial reporting.

(b) They are not recognised as assets since they do not meet the conceptual criteria for recognition. As a consequence, the costs incurred to generate those intangibles are considered as expenses (with a few exceptions), their existence is not reflected through financial reporting. Their variation in terms of cash flow potential (positive as a consequence of opportunities or negative as a consequence of risks) is not reflected either. There are situations where sustainability factors that may negatively impact the enterprise value are not considered: externalities may translate into outside-in financially relevant risks in the future. For example, the conditions to access natural capital may translate at some point in the future in higher costs to access or unavailability of natural capital.

(c) By contrast with the above treatment of internally created intangibles acquisitions of other entities give rise to the recognition of goodwill as an asset by the reporting entity. Goodwill is the difference between the purchase price and the identifiable and controlled assets minus liabilities. Goodwill represent non identifiable and/or non-controlled assets. This is an identified paradox of financial reporting.

23 On the potential upside aspect of recognised assets:

(a) The evolution of the conditions related to the ownership or use of certain assets may trigger an opportunity to increase the derived cash flows beyond the amounts considered at the time of their acquisition.

(b) Financial information gives no or limited information about such situations. For items measured at cost, the principle of prudence focuses on possible downside situations relating to recognised assets when they are getting close to loss-making situations, potential re-evaluations to reflect upside situations are not considered.

24 The third limit to be considered is the retrospective approach on which financial reporting is based.

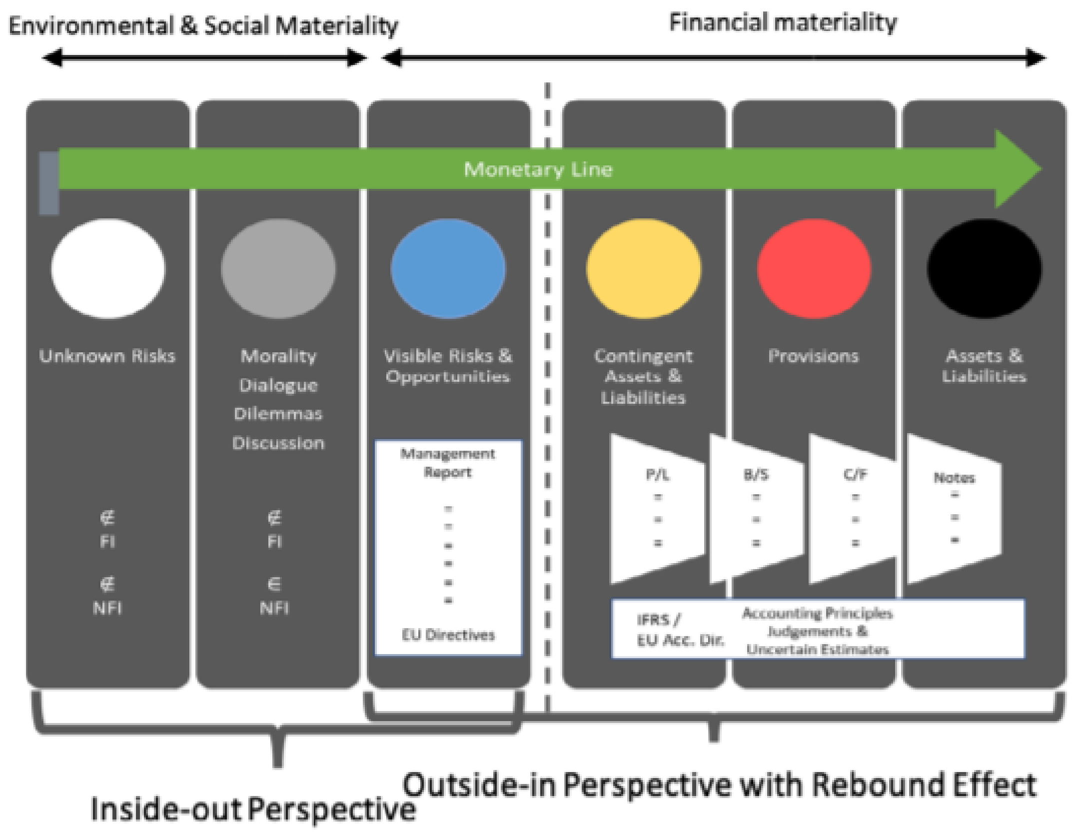
(a) By conceptual design financial reporting provides very limited information on the impact on future cash flows of potential changes in the conditions under which the reporting entity will develop its activities and will as a consequence generate cash flows. The only forward looking dimension is related to the re-measurement of assets and liabilities as illustrated above.

(b) Future cash flows cannot be predicted from past cash flows only, even if past cash flows are a key starting point and a good 'anchor point' for any forward looking analysis. Potential or expected changes in the conditions prevailing in the past are to be considered, in particular when the facts and circumstances under which a reporting entity operates evolve rapidly.

(c) As a consequence, the evolution of the business model is a key factor to understand the cash flow potential of a reporting entity. The evolution may go both ways: towards a decrease (risks exceeding opportunities) or an increase (opportunities exceeding risks) of cash flow potential.

25 Figure 3 below provides an illustration[1] of the dynamics of a non-financial factor becoming financially material for financial reporting; to be read in conjunction with paragraphs 32 to 34 below.

Figure 3



Input from financial analysis on enterprise value creation (and financial materiality)

26 Financial analysis as well as academic and empirical research confirm the need to go beyond financial reporting in order to better capture enterprise value creation.

27 Most valuation models operate from discounted cash flows from the operations developed by the reporting entity. This is related to investment modelling: the return on an investment is the ratio between the cash spent and the cash received over a period of time (plus a terminal value, if any). There may be other models, but they are simplified versions of or practical expedients (or proxies) for discounted cash flow models.

[1] Ref. EFRAG PTF NFRS Report March 2021 – Appendix 4.4 Stream 4 Assessment Report.

28 In this context financial reporting as it stands, i.e. on the basis of the adopted and well established concepts, is considered critical, but not sufficient, to determine what future cash flows will look like. As a consequence other factors have to be introduced in the analysis in order to benefit from credible forecasts. Analysts tend therefore to identify the factors that will influence cash flows (and profitability) and then to quantify their impact. Those factors are sometimes described as 'pre-financial' since they (i) are not (cannot be) recognised by financial accounting and reporting systems but (ii) will ultimately affect financial statements and cash flows at a point in time (once they materialise in terms of assets or commitments, and then in terms of cash…).

29 As illustrated, for example, by the Integrated Reporting[2] Framework developed by the IIRC which a good synthesis of the thought process developed to approach value creation mechanisms, those factors which are financially material may be called «capitals» and may be categorised as comprising:

(d) financial,

(e) manufactured,

(f) intellectual,

(g) human,

(h) social and relationship and

(i) natural capitals.

30 Such a categorisation is to a certain extent conventional and other classifications may be proposed by other frameworks; however it represents a reasonable and acknowledged inventory of influential factors.

31 Beyond the above six categories, capitals may be further subdivided through two focuses:

(a) The ***focus on stocks vs flows of capitals***. Stocks describe the capitals in use by the reporting entity at a reporting date. Flows measure the increase or decrease of capitals over a period of time. Flows can be measured retrospectively or prospectively.

(b) The ***focus on financially recognised/disclosed vs financially unrecognised/not disclosed capitals.*** This focus is the direct consequence of the above described financial accounting and reporting concepts. Integrated reporting tends to put the emphasis on complementing financial reporting. Generally financial and manufactured capitals are considered as properly reflected through financial reporting, so in order to identify the area of sustainability related financial materiality, the emphasis is upon the other four capitals (intellectual, human, social and relationship and natural capitals).

32 As a priority, in order to determine the key trends in terms of future cash flows, analysts tend therefore to investigate the prospective evolution of capitals that are not recognised nor disclosed via financial reporting.

The relationship between the two dimensions of double materiality

33 Financial-related sustainability materiality can derive from two sources:

(a) The reporting entity is affected by external factors (outside-in materiality) that influence its position, development and performance. A classic example is climate change for activities with limited or low GHG emissions. The reporting entity may have limited or no responsibility in terms of climate change and still see its activities heavily impacted (currently or potentially) by climate change. The reporting entity needs to adapt its business model to the new conditions. Adaptation may trigger adverse (inside-out) impacts. Such interaction implies extra attention.

(b) The reporting entity generates significant impacts on environment and/or society (inside-out materiality) and two very different situations in terms of financial related to sustainabilty materiality may be observed:

[2] . IR-Background-Paper-Capitals.pdf (integratedreporting.org)

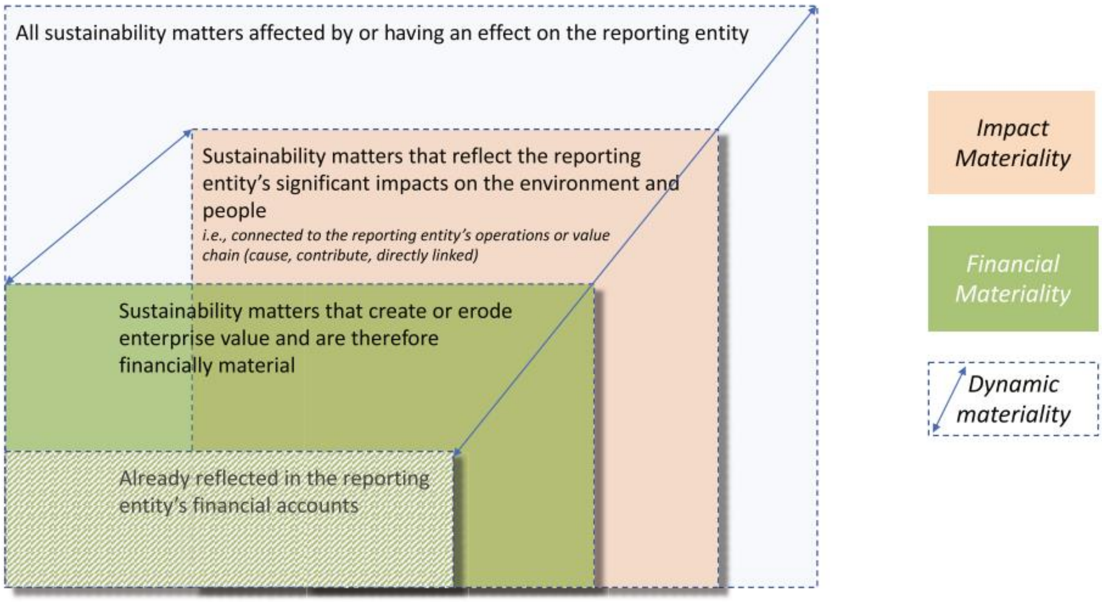
(i) As a consequence of its inside-out impact the entity is itself exposed to significant outside-in impact ('rebound' or 'boomerang' effect). In this situation there is a direct incentive for the reporting entity to mitigate the inside-out impact. E.g. for a company in agriculture, the consequences of depleting land and biodiversity of a field could directly affect the yield of the crops and hence the financial margin.

(ii) The entity has no rebound effect. In this situation, which is probably more common, there is a temptation for the reporting entity to ignore the issue and to maximise its own financial creation at the expense of damage to environment or society. Such situations are sensitive and justify extra attention from a sustainability reporting perspective.

34 Impact materiality (inside-out) and financial-related sustainability (outside-in) materiality have to be considered independently in a cumulative manner. However there may be significant interactions. In such a context it is important to analyse sustainability subject matters from both angles taking into account the existence or not of interactions.

35 The graph below is often used to provide an illustration of this concept[3]. The focus of this Appendix is the dark green area, i.e. financial materiality for sustainability reporting.

Figure 4



How to approach financial materiality for sustainability reporting?

36 Approaching the sustainable development of a reporting entity from a financial standpoint implies embracing all factors that contribute to its long-term development, performance and position. Under a simplified but pragmatic approach sustainability reporting starts beyond the borders of financial reporting.

37 In order to cover the corporate reporting space beyond the financial reporting borders, four sustainability disclosure areas (potential items pre-financial or financial to be disclosed) can be identified. The first two are related to recognised assets and liabilities. The last two are related to 'capitals' that are not recognised by financial accounting and reporting but have a significant influence on the performance and value creation of the reporting entity.

[3] Impact management project.

Sustainability disclosure area 1

*Positive or negative likely impacts on future cash flows of recognised assets and liabilities, resulting from **past events** but with effect on future cash flows not yet recognised (below the more 'likely than not' criterion).*

38 From a sustainability reporting perspective this area covers situations where there are past events justifying a concern (risk), but where the likelihood does not meet the 'more likely than not' criterion applicable to the impairment of an asset or the booking/increase/decrease of a liability from a financial accounting and reporting standpoint. This also leads to addressing situations where, whatever the likelihood, there is an upside potential which is not captured under the principle of prudence (under the historical cost convention) for financial reporting purposes. The goal is different for assets and for liabilities:

(a) From a measurement of assets perspective, the goal is to approach the increase/decrease of the expected cash flows to be derived from the control of the asset in situations where the likely net cash flows remain positive (i.e., do not justify an impairment).

(b) From a liability estimate perspective, the goal is to approach the possible future cash flows resulting from situations that are not 'more likely than not' and are not recognised.

39 To cover this disclosure are, we can envisage two steps:

(a) *Step 1. Situations more likely than not:* The objective is to offer an additional layer of information on the current risks and opportunities related to 'stocks' of assets and liabilities recognised by financial reporting. The key question for this step is: what is the current expected trend in terms of net cash flow generation from recognised assets that are not in an impairment situation? This should cover situations of likely decrease (or increase) of cash flow generation from assets that are not already considered for accounting purposes as generating a negative (or positive) net cash flow in future periods. The decrease or increase is derived from scenarios (forecasts) that are deemed likely to materialise. Disclosures may address assets at risk only or be more comprehensive and identify potential upsides as well.

(b) *Step 2. Situations not more likely than not:* The objective is to offer an additional layer of information on the streams of positive or negative future cash flows, for which the occurrence of risks and opportunities is currently not considered 'more likely than not'. The key question for this step is: what are the financial effects that may derive from such risks and opportunities which do not meet the condition to be recognised? This should cover situations where the likelihood is below the 'more likely than not' level (even if judgmental) but still significant and should go one step beyond disclosure area 1, which is designed to add disclosures on scenarios that are 'more likely than not' but relate to assets/liabilities already recognised.

Sustainability disclosure area 2

*Possible financial risks or opportunities affecting recognised assets or liabilities (i.e. positive or negative likely impacts on future cash flows) that may result from **future events**; their effect on future cash flows is not yet recognised (not deriving from past events).*

40 From a sustainability reporting perspective, this disclosure area covers situations where the likelihood (intensity of risks or opportunities) is expected to increase or decrease as a consequence of future events. Likelihood of financial impact is not static and will evolve as a consequence of future events:

(a) Those future events can be external to the reporting entity (e.g. an anticipated new regulation).

(b) They can also be internal and related to decisions to be taken by the management of the reporting entity. It is the essence of management to minimise risks and to maximise opportunities in a given external context.

41 The objective of disclosure area 2 is to give relevant information on possible (future) events affecting the cash flow generation potential of the reporting entity in relation with assets and liabilities that are or can be recognised through financial reporting. The focus is on tracking emerging or potential situations which following the occurrence of future events may translate into:

(a) The impairment of an asset,

(b) The recognition of a liability,

(c) The decrease/increase in net cash flow generation potential of an asset.

Sustainability disclosure area 3

Disclosure on the currently used capitals that contribute to the creation/maintenance of enterprise value. They do not meet the accounting definition of assets (liabilities) and/or the recognition criteria, but are related to past events.

42 The key question for this disclosure area is: what is the assessment in terms of currently used 'capitals' which are not recognised as assets from a financial recognition standpoint? This leads to address the situation of 'capitals' that are not recognised as assets from an accounting and financial reporting standpoint but have a significant influence on financial performance. The primary goal is to identify those factors of value creation that play a material role in the financial performance of the reporting entity and then to disclose their key features. As explained above:

(a) These items cover factors of value creation that do not meet the separability and control criteria applicable for the recognition of an asset (or liability).

(b) They are multifaceted. For instance: intellectual, human, social and relationship, natural.

(c) To start with they can be approached in terms of position at the reporting date (stocks).

(d) Monetisation is not the only possible measurement. Many metrics of a narrative and non-monetary nature may illustrate the existence and magnitude of 'capitals'.

(e) As for recognised assets and liabilities, the level of likelihood plays an important part here as well: what is the likelihood of the reporting entity receiving financial benefits from the existence of the identified 'capitals'? For 'capitals' the likelihood can also be either over and above or below the threshold of 'more likely than not'; however there is no need to decide on a monetary value which is necessary for recognition under accounting and financial reporting concepts.

43 The objective of disclosure area 3 is to provide relevant information on 'capitals' that cannot be recognised as assets through financial reporting, but have a significant influence on the financial performance of the reporting entity. What are the relevant 'capitals' to describe and what are the narrative disclosures and metrics (of a monetary or non-monetary nature) that reflect their current contribution to the cash flow generation of the reporting entity? The focus is on the description of the key features which illustrate on the reporting date the existence and magnitude of the identified 'capitals' as a result of past events. Since many disclosures (on stocks of 'capitals') are of a narrative or non-monetary nature, the question of likelihood is of lesser importance than for financial reporting assets: nuances in terms of magnitude are possible, the answer is not binary (recognition or not). This does not have to be translated systematically into a monetary amount.

Sustainability disclosure area 4

Disclosure on the future expected developments (related to future events) to the used capital factors that contribute to the creation/maintenance of enterprise value.

44 The key question for this disclosure area is: What are the possible events that may have an influence on the evolution of the 'capitals'? Beyond the existence of stocks of 'capitals', it is key to track flows of 'capitals' to understand better the current and expected financial performance of the reporting entity (impact on retrospective and/or prospective cash flows). As regards the expected evolution, the reasoning is similar to the one followed for recognised assets (see disclosure area 2).

45 The objective of disclosure area 4 is to assess the retrospective evolution of the 'capitals' and, more importantly, to analyse the possible impact of future events on the 'capitals' (identified and described in terms of stocks through disclosure area 3). As regards the prospective dimension the focus is on assessing the risks and opportunities related to the 'capitals' that are critical to the sustainable development of the reporting entity. In this respect the likelihood criterion is more important than for the description of stocks but the nature of the disclosures (narrative, non-monetary, monetary) should help translate accurately the gradation of the exposure of the reporting entity to risks and opportunities.

46 In conclusion, the proposal is to cover the four disclosure areas, to contribute to 'reduce the gap' between financial reporting on the one hand and medium/long term cash flow forecasts on the other hand. It is indeed a contribution to 'reduce the gap' since progress on disclosures can be expected to foster a better understanding of sustainable performance and value creation but will not capture all the elements leading to the ultimate value creation and fully 'fill the gap': the ultimate value is different from the sum of the elements and encompasses subjective elements that are extremely difficult/impossible to measure.

How to identify critical 'capitals' as possible triggers of financial impacts?

47 The triggers to be considered are related to the business model of the reporting entity. The materiality assessment exercise is the process through which the reporting identifies those ESG factors ('capitals') that have or may have an effect on its enterprise value in the short/medium/long term.

48 In line with the 'capitals' mentioned above, the following key questions can be considered. The answer to these questions will support the identification of possible risks and opportunities and related financial effects.

(j) Will the entity be able to continue to use the resources needed in its productive process (including workforce, i.e., human capital)? Inter alia:

- (i) market for the resource and available supply,
- (ii) pricing and margins,
- (iii) resource degradation and remaining useful life, the maintenance or recreation of ability and costs
- (iv) policy/regulatory constraints.

(k) Will the entity be able to continue to rely on the relationships needed in its productive process in the same terms as is currently done? Will the entity's practices trigger an adverse (behavioural or other) reaction? Inter alia:

- (i) financial institutions and providers of financial capital,
- (ii) supply chain,
- (iii) customers (competitive/ethical behaviour, privacy, satisfaction, product impact on health, marketing and communication, product safety),
- (iv) external stakeholders,
- (v) broader society/communities.

(l) Will the entity be able to continue to influence the natural and social capital in order to be able to pursue its own sustainability and financial goals? Inter alia:

- (i) availability of sustainable sources,
- (ii) tolerability of the negative externalities produced by the entity,
- (iii) brand and reputational consequences.

How to rate the level of likelihood (materiality) of sustainability financial related impacts?

49 There are different possible methods to rate the level of likelihood/materiality. Most of them are somehow empirical, they are either (expert) consensus driven or based upon a rational gradation corresponding to the successive steps towards the materialisation of an impact (i.e., an effective cash outflow or inflow).

50 The proposed approach is inspired by a Harvard[4] research paper. The basic idea is the following. Often, there exists a degree of misalignment between the interests of business and the interests of society. In the pursuit of profit businesses may take actions which negatively impact society, either directly through their products (e.g. the public health effects of tobacco use) or through their operations, often viewed as externalities (e.g. the promotion of climate change through the release of greenhouse gases). ESG issues become financially material following a reaction of either the company or its stakeholders to a perceived unbalance between societal benefits (e.g. job creation) and costs (e.g. negative externalities) of the reporting entity.

51 Under the proposed approach, each of the selected factors that are potentially financially material could be ranked in the following successive classes:

(a) Not material: for all the industry, negative impacts on broader society are perceived to be lower than societal value created by the entity.

(b) Low materiality: there is isolated evidence of corporate behaviours that are capturing advantages (positive or negative) in the cost/benefit societal trade off.

(c) Medium materiality: corporate behaviours reach the maximum tolerable level. There is evidence of corporate behaviours triggering adverse reactions from stakeholders or the access to the initial advantage is so widespread by other entities that there is not any more competitive advantage,

(d) High materiality – sector: market practices emerge that aim at rebuilding stakeholders' trust; self regulation.

(e) High materiality – across sectors: the issue is integrated in the competitive landscape; policy intervention.

[4] How ESG Issues Become Financially Material to Corporations and Their Investors? David Freiberg, Jean Rogers, George Serafeim – 2019/2020 Harvard Business School