Dear Regulator,

The Non-financial Reporting Directive (NFRD) revision couldn't occur at a more appropriate time. Not only has the time come for an update of the policy in light of the limitations of the current requirements as highlighted in recent research[1], but the present health crisis is shedding new light on the role of business in society, calling for a new level of accountability that needs to be enshrined in law.

There is mounting evidence[2] that companies oriented towards a multiple bottom line (taking into account the environment, society, profit) are more resilient and have future-proofed strategies even in the current, uncertain context. In other words, those companies are more equipped to respond to emergencies in a meaningful and effective way - ensuring their survival, but also proactively contributing to the welfare of the society they operate in.

The present crisis highlights how swiftly emerging issues can become highly material - causing significant financial impacts. The velocity of the transition from non-materiality to financial materiality has been acknowledged in academic research even before the pandemic outbreak[3], and it is now originating new notions concerning materiality - e.g. dynamic materiality[4].

The idea that materiality can encompass other dimensions beyond the financial one - such as environmental and social materiality, as described in the double materiality concept[5] - is a powerful one, especially when considering that it is possible to find signals that an emerging issue is on its way to become financially material. If investors, corporate decision makers, and stakeholders more broadly were able to identify what issues are becoming financially material, they could be in a position to take action before financial consequences actually occur. This can ultimately lead to better accountability, more transparency, less greenwashing, and better functioning markets.

Given these considerations, we are focusing our feedback letter on the application of the materiality principle.

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[1] Alliance for Corporate Transparency | The Alliance for Corporate Transparency is three-year research project that brings together leading civil society organisations and experts with the aim of analysing the corporate disclosure on sustainability issues by the 1000 largest companies operating in the EU and providing evidence-based recommendations for legislative changes.

[2] ESG funds continue to outperform wider market
[3] https://www.hbs.edu/faculty/Pages/item.aspx?num=57161
[4] Embracing the New Age of Materiality Harnessing the Pace of Change in ESG
[5] Guidelines on reporting climate-related information

OUR RECOMMENDATIONS
17 years ago, in 2003, Simon Zadek and Mira Merme published “Redefining Materiality”, addressing for the first time in a public paper the challenge of transplanting materiality from auditing and accounting to the non-financial domain.

At the time, they noted that “[...] *current experimentation in redefining materiality suffers from being ad hoc, often confused and confusing, and rarely credible. As a result, companies too often disclose information that is not used, incurring unnecessary costs without satisfying intended audiences”*

Although a lot has been achieved since then, their critique still holds. The materiality field is overcrowded with high level definitions and general principles, as highlighted by different literature reviews on the subject[6]. There is a substantial gap at operational level - which leaves companies on their own when it comes to operationalizing these definitions and principles.

Not by chance, the practical requirements Zadek and Merme prescribed for their redefinition to be effective are still largely unmet. Those are:

1. *“An explicit **process** through which the [materiality] tests are applied, which ensures that the required information is identified, assessed and made available to the Board.”*
2. *“A **Board** that collectively has the necessary competencies to be able to make sound decisions on the basis of the information provided.”*
3. *“An **external assurance** of the entire process that is independent, delivered by providers with adequate competencies, and based on standards designed specifically to handle the range and complexity of non-financial as well as financial, and qualitative as well as quantitative, information*”.

Leveraging on these considerations, and our extensive experience working daily with the leading champions in the corporate responsibility field, we share our recommendations for the review of the materiality requirements associated with the NFRD articulating them in 2 main domains: **data** and **governance**.

Data
Among practitioners, a materiality assessment is in many cases trivialized to administering a stakeholder survey, or conducting engagement activities such as workshops or roundtable discussions. While engagement activity is a necessary part of a materiality assessment, surveys

[6] See for example https://link.springer.com/referenceworkentry/10.1007%2F978-3-319-71062-4_43-1

are often ill-responded to and incomplete. Even when not suffering from these issues, surveys remain a subjective source of information - based on opinions and perceptions.

Different sources of information can be leveraged to gather more robust evidence of materiality, ease potential biases in the stakeholders' perspective, support decision-making with comprehensive and accurate data that can shed light on impacts and dependencies - as well as prove useful to different levels of management. Corporate filings, regulations, news, social media posts, academic papers, NGO activism are just some examples of the sources that should be analyzed when conducting a thorough materiality analysis.

Systematic stakeholder dialogue then ensures recoupling of the collected evidence with perceptions and opinions, grounding the discussions in reality and bearing the potential to align conflicting perspectives.

Hence, a **clarification of the nature and typology of the data that can constitute evidence of materiality** (both environmental and social, or financial) in the revised NFRD, has the potential to dramatically improve the quality and reliability of materiality determination processes, promoting an auditable and data-driven approach. There is already significant evidence among practitioners that data-driven approaches yield positive outcomes[7].

It is true that existing frameworks (e.g. GRI, SASB) already provide - to some extent - indications in this direction, but more detail is needed. One interesting example to take into consideration is the new IAASB Extended External Reporting Assurance[8], which includes detailed lists of documental sources that can be leveraged to identify evidence of interest and/or impact.

In other words, lists of sources that ought to be analyzed, examples of what pieces of information provide evidence of stakeholders' interest or (financial and non-financial) impact, as well as an explanation of the characteristics (e.g. traceability, time specificity, reliability) of the data, are some elements that can ensure that the revised NFRD provides actionable guidance on materiality.

Finally, clarifying the nature and typology of the data involved in the materiality determination process, would provide the opportunity to orchestrate in more harmony the different ingredients that are needed in the assessments: tests, judgements, impacts, salience, time horizons, financial perspective, stakeholder perspective.

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[7] https://www.datamaran.com/customer-stories/
[8] http://www.iaasb.org/projects/extended-external-reporting-eer-assurance

Governance
The accountability of the materiality determination process resides in the companies themselves. Indeed, only companies are in the position to judge - in the light of their strategies, capabilities and resources linked to their stakeholders' expectations and market conditions - what is material to them and what might become material in the future. More importantly, there is general consensus[9] that materiality judgements fall within the mandate of the Board of Directors. Yet, application of this foundational principle is dismally limited.

Given the abundance of high-level definitions and principles, and the lack of standardized operational procedures, every company solves the materiality puzzle with ad hoc and inconsistent processes - failing to connect materiality to strategy and risk management, and ultimately to draw the Board attention and ensure its preparedness to make informed decisions on emerging risks and opportunities.

A rules-based approach (i.e. pre-determined lists of material issues) would not solve the governance problem either. While those approaches may be based on extensive and authoritative research (such as the case of SASB indicators), they take away from the Board the accountability of making materiality judgements. It provokes box-ticking.

The introduction of a standardized procedure, clarifying internal organizational bodies involved, prescribing the frequency of the analysis - at least annual, aligned with the reporting cycle, and third-party audit, would have a substantial impact on the integration of non-financial issues in the core decision making processes. Interestingly, there are already a number of examples of policies that are introducing governance requirements in order to promote a more structured and standardized approach to identify material risks and opportunities. The Italian Insurance Authority (IVASS) regulation 38[10] provides a good example of how a regulation can strike a good balance between a principles-based and a rules-based approach.

Regulation 38 main provision concerns the creation of an "adequate system of corporate governance" with the aim of "identifying, assessing, and managing in an adequate way the monitoring of current and prospective risks". The regulation explicitly includes "risks with environmental and social nature". In addition, the regulation specifies that "risk categories should be identified regardless of the capability to quantify them", opening the scope of the provisions to potentially any kind of emerging risk.

In relation to the previous point, the regulation indicates that "the company has to define procedures to provide evidence in a timely manner of the emergence of medium-long term

[9] See Eccles and Youmans (2015): Materiality in Corporate Governance: The Statement of Significant Audiences and Materiality

[10] IVASS - IVASS Regulation No. 38 of 3 July 2018

material risks". In other terms, it is true that all potential risk categories should be considered regardless of their measurability, but the organization has to set up processes to provide evidence of their materiality.

Finally, according to Article 6, a Risk and Internal Control Committee must be established, prevalently composed by non-executive independent directors. The Committee assists the board in the risk identification and management, and audits the adequacy of the risk governance system.

FINAL CONSIDERATIONS

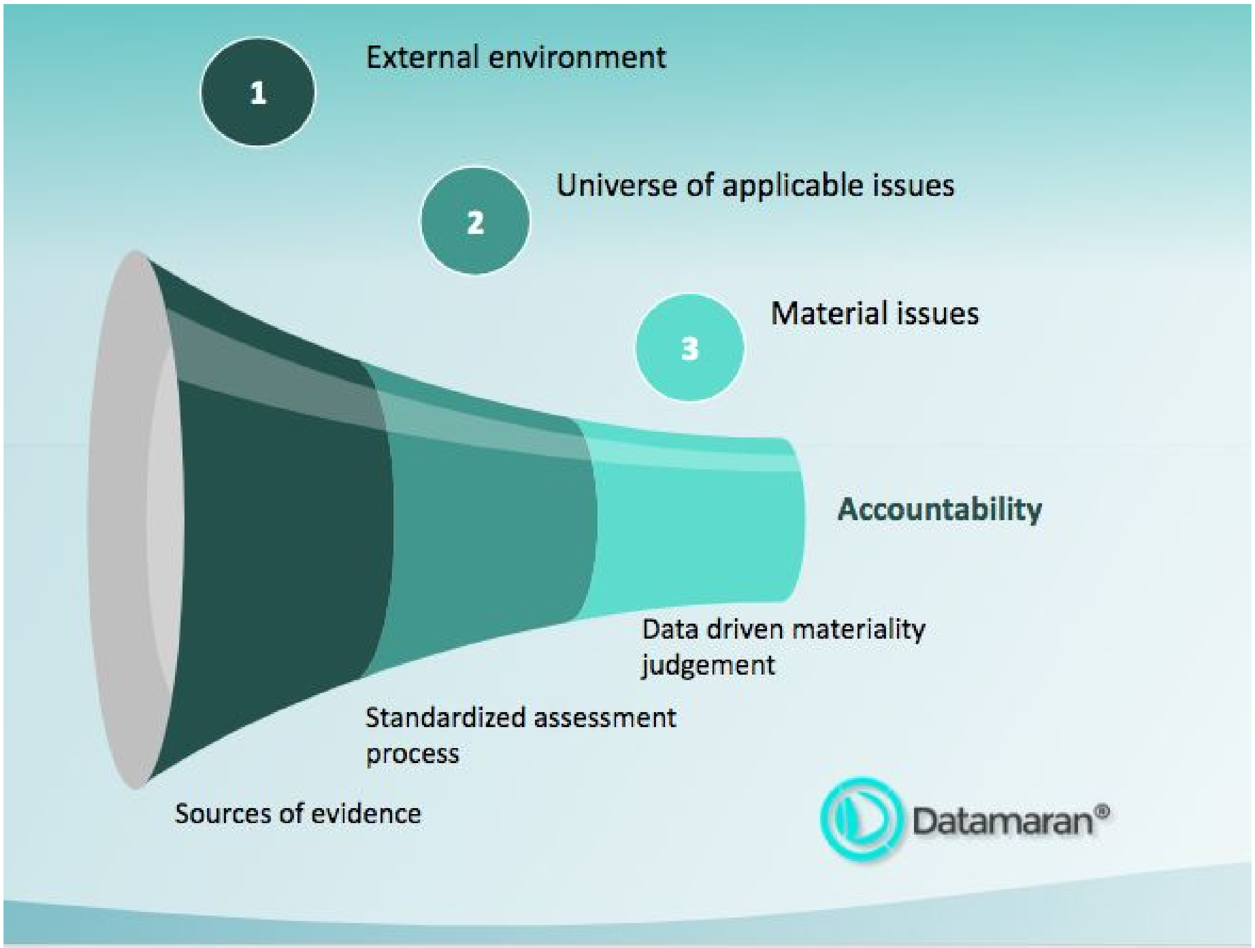
One concern may be that this robust process may further burden the already resource demanding reporting process. There are at least 3 considerations responding to this argument.

First, technology (e.g. big data analysis, artificial intelligence, natural language processing) has a dramatic impact on resource efficiency, allowing to analyze large amounts of information at a relatively low cost, ensuring at the same time accuracy of analysis, quality and auditability of data, and comprehensiveness of insights.

Second, by refocusing the performance indicators on material aspects and measuring them based on standardized methodologies, the burden can be eased. If a company follows a standardized and globally recognized materiality assessment procedure to identify its material impacts based on which it can define its key performance indicators, it can legitimately focus solely on these. In other words, sustainability/ESG rating agencies or investors should take into account a company's materiality determination process and should not penalize lack of disclosure on non-material indicators.

The third consideration ties directly to the second domain - governance. Indeed, materiality shouldn't be considered exclusively within the boundaries (and the budgeting) of the reporting activity, but should be regarded as the foundation for a more complete strategic risk management process.

Data driven materiality, based on a robust standardized procedure, would allow to move beyond the current perspective that in the non-financial domain, companies' accountability consists in a long list of indicators to disclose on - a shopping list that is more a chore than anything else. It would bring back corporate accountability where it belongs - to the Board. Beyond this, it would provide the actionable tools needed to help business focus on what really matters and ensure the necessary audit trail to defend the process.



The NFRD revision is a unique opportunity not only to foster transparency and promote better functioning markets, but also and, more importantly, to drive authentic change. We firmly believe, thanks to our experience of working every day with the corporate leaders in the Datamaran community, that our recommendations can provide a substantial contribution to give to accounting and reporting the transformational power that inspired the Regulator in taking the bold decision of becoming the pioneer policy maker in this field.

We look forward to seeing the outcome of your policy making activity and we hope that our contribution will help you with your ambitious mandate.

Best regards,
The Datamaran Team