European corporate sustainability reporting - The Financial Materiality Compass as an auxiliary tool

Christina E. Bannier[1] and Henry Flach[1]

[1]Chair of Banking & Finance, Justus Liebig University Giessen

Introduction

- All companies covered by the Corporate Sustainability Reporting Directive are obliged to apply the European Sustainability Reporting Standards (ESRS).
- The ESRS contain 2 general standards and 10 topic-specific standards (5 environmental-, 4 social- and 1 governance-standard).
- ESRS 1 includes a mandatory materiality analysis with regard to the financial and impact materiality of certain sustainability topics.
- This poses particular challenges for smaller companies with limited resources.

Research aim

- Identification of the financially material sustainability issues according to the 10 ESRS sustainability topics for companies from 11 different sectors.
- Financial Materiality Compass (FMC) as a science-based tool for companies to start and conduct their materiality analysis.

Data & Methodology

Three different analysis steps

Panel-data regressions:

- 1.914 publicly listed European companies between 2010 and 2021 grouped in the 11 sectors according to the Global Industry Classification Standard®; Data retrieved from Refinitiv.
- System generalized method of moments (GMM) estimatior by Arellano-Bover/ Blundell-Bond (Arellano & Bond,1991; Blundell & Bond,1998).
- Dependent variables: 9 measures of firm financial performance; Independent variables: 10 sustainability category scores.
- 9 regressions for each sector; number of significances of each sustainability category as indicator of financial materiality.
- Results indicate a first-step FMC.

Sustainability report analysis:

- Descriptive analysis of sustainability reports from 2022/23 of 293 listed European companies.
- Development of a second-step FMC.

Expert Interviews:

- Presentation of a combined FMC to 7 financial ESG Experts for comments and shifts in materiality intensities.
- Development of the final FMC from the mean values of the interview results.

Results

Financial Materiality Compass	E1	E2	E3	E4	E5	S1	S2	S3	S4	G1
Communication Services	1	0	0	0	0	1	2	0	1	1
Consumer Discretionary	2	1	0	2	1	2	1	0	1	2
Consumer Staples	2	1	1	2	1	1	2	0	1	1
Energy	2	1	1	1	1	1	1	1	0	1
Financials	1	0	1	0	1	2	1	0	1	1
Health Care	1	0	0	1	0	1	0	0	1	1
Industrials	2	1	0	1	1	1	1	2	0	2
Information Technologies	1	0	0	0	1	2	0	0	1	1
Materials	1	1	0	1	1	1	1	1	0	1
Real Estate	1	0	0	0	0	1	0	0	1	2
Utilities	2	1	1	0	0	2	0	1	1	2

- Categories *E1 climate change, S1 own workforce* and *G1 business conduct* are either weakly (1) or strongly (2) financially material for all sectors considered.
- Categories *E2 pollution, E3 water and marine resources, E5 circular economy,* and *S4 consumers and end users* exhibit only weak financial materiality if at all.
- We observe the largest number of strongly material sustainability categories in the consumer discretionary sector where four ESRS categories turn out to be strongly material. This is followed by consumer staples, industrials and utilities with three ESRS categories being strongly material each.

Conclusion

- Clear differences in the financial materiality of ESRS sustainability categories across the various sectors.
- Even the heavily discussed sustainability topics of *E1 climate change* and *S1 own workforce* are not strongly material for all of the 11 sectors.
- While a comparatively large number of sustainability categories display some financial materiality across the sectors considered (75 instances), only few of these (18, i.e. about a quarter) show a strong financially material impact.
- If firms were to report only on the strongly material sustainability categories, this would hence significantly limit their reporting needs.

References & Further Information

JUSTUS-LIEBIG-UNIVERSITÄT GIESSEN

References

- Arellano, M., & Bond, S. 1991. Some Tests of Specification for Panel Data: Monte Carlo Evidence and an Application to Employment Equations. Review of Economic Studies, 58 (2), 277–297. https://doi.org/10.2307/2297968
- Blundell, R., & Bond, S. 1998. Initial conditions and moment restrictions in dynamic panel data models. Journal of Econometrics, 87 (1), 115–143. https://doi.org/10.1016/ S0304-4076(98)00009-8

Contact

Henry Flach
Justus Liebig University Gießen
E-Mail: Henry.Flach-1@wirtschaft.uni-giessen.de

Working Paper

SCAN ME