

The Concept of the Reporting Entity and Dual Materiality in Sustainable Reporting

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Abstract- To determine the boundaries of the reporting entity in good faith, it is necessary to consider the rights of stakeholders. The sustainability report applies to the same reporting entity as the financial statements. Financial statements are prepared from the perspective of investors using financial materiality criteria. The inclusion of the direct and indirect business relationships of the entity allows for the expansion of the scope of materiality by assessing the significant impacts, risks, and opportunities associated with its activities. They require assessment and justification of the decision to include them in the determination of materiality, which is differentiated into impact materiality and financial materiality. These circumstances are considered upstream and/or downstream in the value chain of the entity. There is a need to document the decision to include information about the value chain only in relation to the parts of this chain for which the issue is material. For sustainability reporting, the materiality principle is transformed into the principle of double materiality. Accordingly, the financial statements include a new component – a sustainability report, part of the organization’s annual report. There is a transformation of the financial reporting related to sustainability into a separate, structured sustainability report, part of the organization’s annual activity report. Resources for preparing quality sustainability reports are found in using accounting methods for current reporting through a certain analytical approach and assessment of significant impacts, risks, and opportunities. The methods of analysis and synthesis, observation and comparison, analogy, documentation, and modeling are used. The implementation of the proposed analytical accounting facilitates the preparation of the sustainability report. The documents prepared to include information on the value chain provide evidentiary value of the decisions made for the organization’s sustainability.

Keywords- reporting entity, dual materiality, accounting, sustainability, report.

I. INTRODUCTION

Sustainability requires the responsibility of today’s management to future generations. Sustainable development is often defined as “development that meets the needs of the present without compromising the ability of future generations to meet their own needs.” [15] Sustainability reporting requires not only formal contractual relationships with suppliers, customers, and employees, but also the informal and indirect business relationships of the enterprise. There are blurred boundaries of relationships, creating a mesoenvironment that operates at the boundaries between the micro and macro environments of the enterprise. The mesoenvironment creates an opportunity to expand the scope of the reporting organization to include the impact of actual and potential business relationships on sustainability.

The concept of the accountable enterprise finds its origin in the need for everyone to be responsible for their activities and to receive a reward or profit for the work done by them. In this sense, the organization has an interest in differentiating and addressing its efforts in a way that allows for both costs and assets, as well as revenues and liabilities, to be accounted for in the process of forming and maintaining sustainability. Sustainability in the channel for sustainable solutions is created and maintained by the rights and obligations of interested parties. In this regard, for the mesoenvironment, public accountability “is expressed in the obligations of individuals and organizations, including state-owned enterprises, to which state funds are provided, to bear fiscal responsibility, managerial responsibility and responsibility for the implementation of programs, as well as to be accountable to those who have provided them with these responsibilities.” [2, 20-21] Therefore, the concept of the reporting enterprise applied in the mesoenvironment of the

Online ISSN 2256-070X

<https://doi.org/10.17770/etr2025vol1.8649>

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organization provides a distribution channel for sustainable solutions.

The nature of a reporting entity is defined in the 2018 Conceptual Framework (the Framework), which states that "A reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity." [21, par. 3.10] The determination of sustainability requires taking into account the influence of the communicative nature of the activities performed by the organization not only from suppliers, customers and appointed persons, but also from the end users of the production organizations' output. The path to reach the end users is defined as the marketing distribution channel for the organization. Stern and El-Ansari define marketing channels as "a set of interdependent organizations involved in moving a product or service to the consumer." [9] Sustainability, formed by the relationships between the participants in the distribution channel, finds expression as a marketing dialogue that "emphasizes the communicative nature of all activities of sellers and buyers." [6] The commitment of each of the participants in the distribution channel requires responsible business behavior, which finds expression in the Global Reporting Initiative (GRI), founded in Boston (USA) in 1997 [24].

TABLE 1 COSTS FOR ENVIROMENTAL, SOCIAL AND GOVERNANCE SUSTAINABILITY

| № | Costs For Sustainability | | |
|----|--------------------------|--|--|
| | № | Scope of classification | Classification |
| 1. | 1.1. | For the purpose of control from the point of view of occurrence | Costs for restoring a disturbed ecological balance |
| | 1.2. | For the purpose of control from the point of view of occurrence | Costs for preventing the disturbance of the ecological balance |
| 2. | 2.1. | For the accounting purposes and the relationship of expenses to the financial statements of the entity | Internal environmental costs |
| | 2.2. | For the accounting purposes and the relationship of expenses to the financial statements of the entity | External environmental costs |

From the beginning, GRI's goal has been to "work to further publicize information that goes beyond a simple sustainability perspective to include social, economic and governance issues." [5] The contribution of GRI is that it "creates a global common language for organizations to report their impacts - which enables informed dialogue and decision making around those impacts." [24] Twenty-five years later, the sought-after sustainability of business relationships finds a natural expression in CSR and ESRS as a value chain formed both between the individual objects of an enterprise and between enterprises created on the basis of capital, contractual or consumer relationships. Both financial and non-financial information on the

impacts, risks and opportunities formed in the meso environment is necessary for sustainability reporting. Therefore, "when determining at what level (within its own activities and down and up the value chain) a given material sustainability issue arises, the enterprise uses the assessment of impacts, risks and opportunities that it has made, observing the principle of double materiality." [17, par. 66] As a concept providing a comprehensive view of environmental costs, applicable also to social and management sustainability costs, the classification of B. Yonkova (1, p. 174), presented in Table 1, can be accepted.

By searching for the relationships in environmental, social and governance sustainability, a new concept is defined "as the "triple bottom line", considering simultaneously environmental, social and financial results" (8, 77).

II. MATERIALS AND METODS

The availability of financial and non-financial information on environmental, managerial and social sustainability allows for a better explanation of social processes through the sociological theory of structural functionalism [11], (H. Spencer, M. Durkheim, T. Parsons), explaining the structures and functions of society. From the point of view of the economic aspect of the behavior of individuals and organizations, the sociological theory of exchange is applicable, the subject of study of which is the normative-value side of the exchange processes. [11] At each level in the value chain, a basic activity-behavioral model can be organized in control, with which two effects of influence can be used - the effect of the coercive order and the effect of creative expression, which, taken together, will lead to a greater overall effect of the functioning of the organization. The basis of the activity-behavioral model "is the idea of the dual nature of labor - as activity and behavior." [4] The activity-behavioral approach proposed in the model is the result of a comparison of two other approaches to management – the institutional-activity and the motivational-behavioral. The first of these is characterized by the fact that it institutionalizes relations and regulates the rules. It applies the concept of typical design and in controlling the organization it is characteristic to introduce a completely new management, strict regulatory control by the regulator and strong bureaucracy. In the motivational-behavioral approach, centralization is displaced and modern marketing management tools are applied, concretizing in "social management".

Financial statements are prepared from the perspective of investors using financial materiality criteria. The inclusion of the direct and indirect business relationships of the enterprise allows for the expansion of the scope of materiality by assessing the significant impacts, risks and opportunities associated with its activities. They need evaluation and justification of a decision for their inclusion in determining materiality, which is differentiated into materiality of impact and financial materiality. These circumstances are considered

upstream and/or downstream of the enterprise's value chain. There is a need to document the decision to include information about the value chain only in relation to the parts of this chain for which the issue is material. For sustainability reporting, the materiality principle is transformed into the principle of double materiality. In DR (EU) 2023/2772, the concept of dual materiality is defined and it is determined that dual materiality has two dimensions, namely: impact materiality and financial materiality (16, ESRS 1, par. 37). The impact needs up-to-date reporting tools. A sustainability issue is material from an impact perspective when it relates to the significant actual or potential, positive or negative impacts of the entity related to its own activities, upstream and downstream of its value chain. (16, ESRS 1, par. 3.4). The financial materiality of a sustainability issue is not limited to matters that are under the control of the entity, but includes information on significant risks and opportunities arising from business relationships outside the scope of consolidation used in the preparation of the financial statements. Dependencies on natural, human and social resources may be a source of financial risks or opportunities. The significance of risks and opportunities is assessed based on a combination of the likelihood of occurrence and the potential magnitude of the financial consequences (16, ESRS 1, par. 3.5).

The problem of sustainability in the value chain is directly related to the "transformation" of a company's potentials in markets and segments in them, making up its company strength. Under the concept of "transformation" we take the meaning of the word "transformatio" in the sense of "art of changing some values with others".[10] With certain changes in strategy, size of organizations, management technology and the surrounding environment, the value chain is restructured, and accordingly restructures the structures involved in the organizational units. System dynamics and structural sustainability of relationships are of interest for the long-term, mid-term and operational sustainability reporting. Certain difficulties may arise in the accumulation of information in connection with sustainability reporting. These difficulties may be caused by a lack of analytical accounting or market information. According to the ESRS, the reporting entity is relieved during the first three years of sustainability reporting. In this case, "the entity explains what efforts it has made to obtain the necessary information for its value chain upstream and downstream, the reasons why it could not obtain all the information, as well as its plans to obtain the necessary information in the future." [16, par.132] As can be seen, non-financial information for sustainability reporting is descriptive in nature. It, as well as the information included "in the annex to the Annual Financial Statements, descriptive information means descriptive, non-financial information that complements and enriches the financial information in the components of the financial statements." [13]

The annual report of the organization includes a new component – a sustainability report, part of the annual report of the organization. There is a transformation of the financial reporting related to sustainability with a separate, structured sustainability report. Resources for preparing quality sustainability reports are found in the use of accounting methods for current reporting through certain sub-accounts and analytical and assessment of significant impacts, risks and opportunities. Analytical reporting should be directed in accordance with the requirements of the sustainability report according to ESRS, and the sub-accounts and analytical accounting accounts for costs and revenues related to environmental, social and governance sustainability should be described in the accounting policy of the organization.

III. RESULTS AND DISCUSSION

When identifying and assessing impacts, risks and opportunities along its value chain to determine their materiality, an enterprise shall focus on areas where impacts, risks and opportunities are considered likely to arise, based on the nature of the activity, business relationships, geography or other factors. In line with the requirements of the CSRD, the list of sustainability issues on which enterprises are required to disclose information should be aligned as closely as possible with the definition of 'sustainability factors' set out in Regulation (EU) 2019/2088 and avoid any inconsistency between the information required by data users and the information that enterprises should report. [18, par. 28] 'Sustainability factors' means environmental, social and employee-related issues, as well as issues related to respect for human rights and the fight against corruption and bribery. [19] It is evident that the marketing dialogue model supports the definition of the value chain and plays an important role in determining the materiality of the impact. The threshold and compensating factors also serve to define the "sustainability factors". The result is a model of the marketing dialogue between manufacturer, distributor and retailer, supporting the assessment of the materiality of the impact, shown in in Fig. 1 [15] Reporting of sustainability is carried out in compliance with the accounting principle of priority of substance over form. First, costs are accrued by economic elements (by content), then the costs are transferred by types of activities (by form). The risks associated with receivables and payables require the use of the principle of caution - maintaining increased attention when making judgments under conditions of uncertainty. Issues related to deviations from environmental standards may have an impact on the recognition, measurement and reporting of liabilities in the financial statements, which are applied in accordance with IAS 37 Provisions, Contingent Assets and Contingent Liabilities. According to IAS 37, it is necessary to disclose the nature of provisions or contingent liabilities and indicate the uncertainty about the amount or timing of the related economic flows (IAS 37, para. 85-

86). Costs by economic elements are incurred for materials, external services, depreciation, payroll, social security and others. Sustainability costs are also incurred for the purchase of long-term assets used to ensure environmental, social and management sustainability. According to the degree of aggregation of accounting data, accounting accounts for sustainability reporting are divided into synthetic and analytical. Synthetic accounts reflect information on the prevailing common properties of homogeneous groups of assets, liabilities, income and expenses. To account for the functional purpose of the objects generating environmental, management and social sustainability and in order to support the preparation of sustainability reports, it is necessary to create

decomposed, more detailed accounting information. "This is achieved by maintaining analytical accounting accounts to a given synthetic main accounting account." [3] Along with monetary ones, natural measures can also be used. In order to introduce differentiated information on sustainability, sub-accounts can also be used, which "are introduced when, within a synthetic account, it is necessary to perform an additional (intermediate) grouping of reporting objects." [12] In addition to the expenses incurred on a cash basis for the period, it is necessary to create accounting information for sustainability through analytical reporting on the receivables and payables of enterprises on an accrual basis.

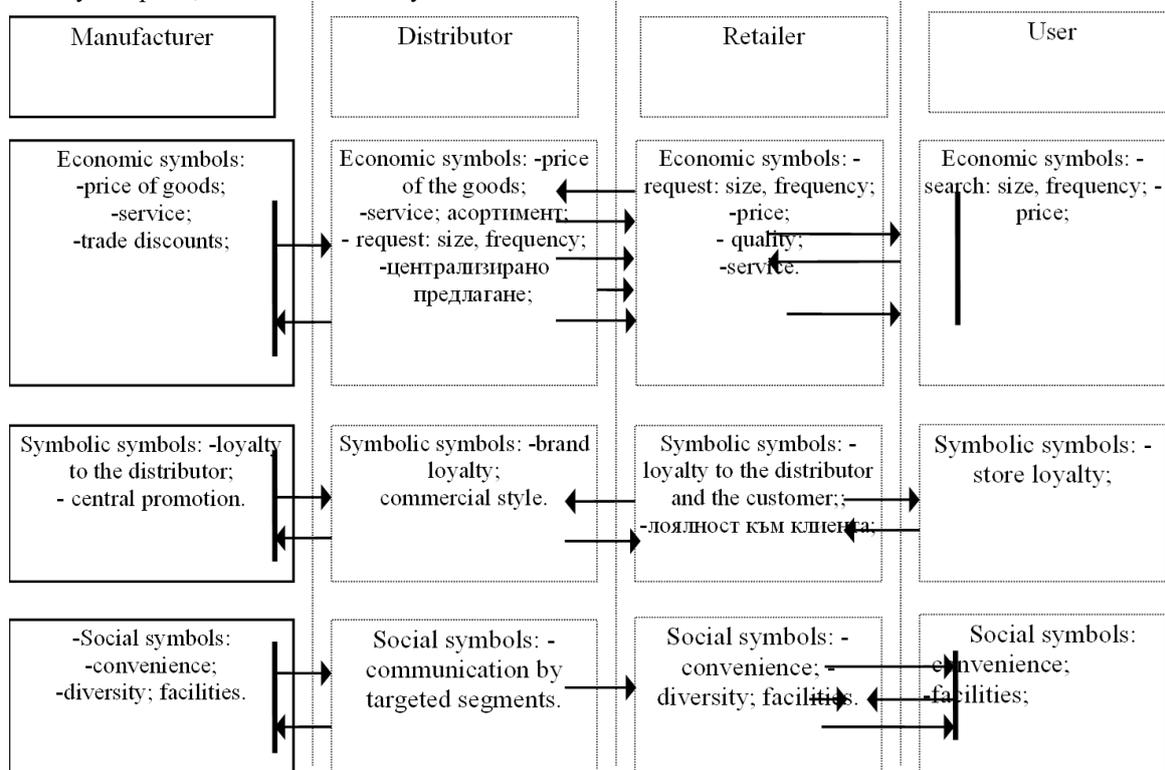


Fig. 1. Marketing dialogue model in the distribution channel.

For receivables reported with the active accounting account "Receivables", accrual can be illustrated with the example shown in Table 2. Analytical reporting can also be organized by clients, by payment terms, by client country, etc. For liabilities, sustainability analytics is also created, as they are reported on a synthetic passive accounting account "Payables to suppliers".

To account for sustainability, the system of analytical accounts to the synthetic account "Receivables" has the form shown in Table 3.

The sustainability report regulated by the ESRS [17, 115] is part of the annual report on the activities of organizations. In order to verify the completeness and correctness of the accounting entries regarding environmental, social and management sustainability, an analytical turnover sheet is prepared. "From the turnover sheets for analytical accounts, changes (increases or

decreases) of each reporting object can be established. Therefore, they are an important source of information that is used to control and analyze business activity". [7] That is why they have an important place in providing accounting information for inclusion in the sustainability report.

In support of the claims that the enterprise is a going concern, the sustainability report includes off-account information. This information represents opinions, statements, and others that give rise to grounds for reporting specific transactions and operations in a future period, but are not accounted for and do not give rise to financial effects in the current period. For example, a concluded supply contract covering a future period should be entered into the accounting system off-balance sheet in the current period, but is not reported on the balance sheet

accounts. The information and statements should not be accounted for, but should support forecasts and projections of the organization's sustainability in different time horizons.

TABLE 2 ACTIVE SYNTHETIC ACCOUNTING ACCOUNT "RECEIVABLES"

| № | Synthetic Accounting Account "Receivables" | |
|----|--|------------------------------|
| | Debit | Credit |
| 1. | Opening balance | |
| 2. | Debit turnover – increasing | Credit turnover – decreasing |
| 3. | Amount of debit turnover | Amount of credit turnover |
| 4. | Debit total | Credit total |
| 5. | Ending balance | |

TABLE 3 ANALYTICAL ACCOUNTS FOR SUSTAINABILITY TO THE SYNTHETIC ACCOUNTS "RECEIVABLES"

| № | Analytical Accounts For The Sustainability To The Synthetic Accounting Account "Receivables" (Separately for Materials, External Services, Depreciation, Salaries, Social Security and Others) | | | | | |
|-----|--|--------|--|--------|--|--------|
| | Analytical Account "Environmental sustainability" | | Analytical Account "Social Sustainability" | | Analytical Account "Management Sustainability" | |
| 1. | Debit | Credit | Debit | Credit | Debit | Credit |
| ... | | | | | | |

Accountants prepare approximate accounting estimates of the effects of future business operations, through which they establish predictable financial values. The preparation of a forecast included in the sustainability report should be guided by the International Standard on Assurance Engagements 3400: Review of Prospective Financial Information, which states that "Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires the exercise of considerable judgment. Prospective financial information can be in the form of a forecast, a projection or a combination of both, for example, a one year forecast plus a five year projection. (23, para. 3) In order to assess the materiality of the impact along the value chain and determine financial materiality, it is important to project the activities in operational, medium-term and long-term periods. The business relationships that have arisen should be assessed. The sustainability of the activities is also assessed. Therefore, in order to take sustainability into account, a "Projection of Future Opportunities" is prepared. „A "projection" means prospective financial information prepared on the basis of:

(a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a

start-up phase or are considering a major change in the nature of operations.

or

(b) A mixture of best-estimate and hypothetical assumptions.

Such information illustrates the possible consequences as of the date the information is prepared if the events and actions were to occur (a "what-if" scenario)". (23, para. 5)

Therefore, the preparation of predictive and projective information supports the application of the concept of dual materiality. For example, when acquiring a company, the preparation of the organization's value chain can use an analysis of the activities ensuring its sustainability:

„1st rank: Macro-environment in the areas: "Acquired company" - Society - Ecology.

Threshold and compensatory factors for the transformation of the interest in transfer, generated by the marketing environment.

2nd rank: Analysis of the industry environment in the areas: "Acquired company" - Strategic business unit /SBU/ - Industry.

Threshold and compensatory transformation factors of the industrial environment.

3rd rank: Analysis of the company's environment in the areas: "Acquired company" - Product - Market.

Threshold coefficients for marketing transformation:

PC1= Sales by products and markets/marketing costs by products and markets

PC2= Market share by products/marketing costs by products. "(14, 88)

Company compensatory factors are also prepared. Such an analysis can be used to draw up the reporting entity's value chain and to demonstrate it as a going concern.

IV. CONCLUSIONS

Non-financial information for sustainability reporting is descriptive in nature. Transformations in the value chain occur when threshold sustainability factors are crossed. At a lower level in the value chain, there are compensating factors, the change of which does not lead to transformation, but to a change in a given local area of sustainability. For the three ranks (macro, meso and micro environment of the enterprise), threshold and compensating factors are defined, based on specific adjustable parameters and indicators. The result is a model of the marketing dialogue between the manufacturer, distributor and retailer, supporting the assessment of the materiality of the impact. The main impacts, risks and opportunities of a given enterprise are similar to the material impacts, risks and opportunities established in accordance with the principle of double materiality, reported in its sustainability report. The marketing dialogue model supports the definition of the value chain

and plays an important role in determining the materiality of the impact. The threshold and compensating factors also serve to determine the “sustainability factors”. To account for the functional purpose of the sites generating environmental, management and social sustainability and in order to support the preparation of sustainability reports, it is necessary to create decomposed, more detailed, analytical accounting information. In order to verify the completeness and correctness of the accounting entries regarding environmental, social and management sustainability, an analytical turnover sheet is prepared. The preparation of predictive and projective information supports the application of the concept of dual materiality.

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