

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG FR and SR TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG SRB or EFRAG SR TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG SRB, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Financial materiality in MAIG FAQs

Cover note

Objective

1. The objective of this session is to obtain inputs from EFRAG FR TEG members on the FAQs, specifically FAQ 5 and FAQ 6, that deal with financial materiality in the implementation guidance on the materiality assessment ('MAIG') currently being prepared by EFRAG Sustainability Reporting.

Background

2. In March 2023, Commissioner McGuinness publicly called on EFRAG to prioritise implementation guidance on the first set of ESRS over the preparatory work for the draft sector-specific standards. EFRAG therefore adjusted its workplan accordingly and allocated resources for the task.
3. The EFRAG SRB concluded based on its members interactions with constituents that the highest priority is implementation guidance on the materiality assessment as well as value chain information.
4. In the Explanatory Memorandum to the delegated act issued in July 2023, the EC notes that *The Commission is putting in place an interpretation mechanism to provide formal interpretation of the standards. The Commission has also asked EFRAG to publish additional guidance and educational material, addressing the materiality assessment process and other issues.*
5. In the Q&A document that accompanies the delegated act, the EC notes that: *EFRAG will periodically publish additional non-binding technical guidance on the application of ESRS. ...The Commission has suggested that EFRAG prioritises the development of guidance on materiality assessment and on reporting with regard to value chains. EFRAG expects to publish draft guidance on these two issues for public consultation in the near future.*

Important information

6. EFRAG can only issue non-authoritative guidance in its role as technical advisor to the EC.
7. Furthermore, while drafting guidance, EFRAG cannot develop concepts or requirements that go beyond the content of the July 2023 delegated act. The guidance aims to illustrate the delegated act but not go beyond it. For new provisions, separate standard-setting activities in accordance with that process has to be concluded.
8. The content of the guidance presented has not been validated by the ISSB, GRI or FISMA.



9. EFRAG is also in the process of establishing a process to answer questions from constituents similar to the IFRIC decisions under the IFRS framework.

Next steps

10. The implementation guidance will be approved for public feedback release by the SR TEG early November 2023 and by the SRB mid-November 2023. This is a four-week public feedback period that will lead to a redeliberation at the SR TEG and SRB level prior to its final release by EFRAG.

Definition of financial materiality in ESRS

11. The definition of financial materiality is set out in section 3.5 of ESRS 1 and its accompanying Application Requirements in para AR 13-15 (refer to the Annex for the text).

Financial materiality FAQs in the MAIG

12. The discussion will be on the FAQs detailed below (refer to Agenda paper 06-02).
 - i) FAQ 1: Is materiality for financial statements and management commentary the same as financial materiality for the sustainability statement?
 - ii) FAQ 2: Is financial materiality for the sustainability statement limited to effects presented in financial statements?

Agenda papers

13. In addition to this paper, the EFRAG Secretariat presents the following additional papers:

- Agenda paper 06-02 DRAFT Materiality Assessment Implementation Guidance 18 October 2023. *Note for SR TEG members: this is the same agenda paper 04-02 Draft Materiality Assessment Implementation Guidance 17 October 2023.*

Questions for EFRAG FR and SR TEG members

14. Do EFRAG FR and SR TEG have further comments on FAQ 5 and FAQ 6 of the Materiality Assessment Guidance ?



APPENDIX

Introduction

1. This appendix provides extracts of the relevant paragraphs from ESRS 1 for ease of reference.

ESRS 1 General Requirements

3.5 Financial materiality

47. The scope of **financial materiality** for sustainability reporting is an expansion of the scope of materiality used in the process of determining which information should be included in the undertaking's financial statements.

48. The **financial materiality** assessment corresponds to the identification of information that is considered material for primary users of general-purpose financial reports in making decisions relating to providing resources to the entity. In particular, information is considered material for primary users of general-purpose financial reports if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that they make on the basis of the undertaking's **sustainability statement**.

49. A sustainability matter is material from a financial perspective if it triggers or could reasonably be expected to trigger material **financial effects** on the undertaking. This is the case when a sustainability matter generates **risks** or **opportunities** that have a material influence, or could reasonably be expected to have a material influence, on the undertaking's development, financial position, financial performance, cash flows, access to finance or cost of capital over the short-, medium- or long-term. Risks and opportunities may derive from past events or future events. The **financial materiality** of a sustainability matter is not constrained to matters that are within the control of the undertaking but includes information on material **risks** and **opportunities** attributable to **business relationships** beyond the scope of consolidation used in the preparation of financial statements.

50. **Dependencies** on natural, human and social resources can be sources of financial **risks** or **opportunities**. Dependencies may trigger effects in two possible ways:
 (a) they may influence the undertaking's ability to continue to use or obtain the resources needed in its business processes, as well as the quality and pricing of those resources; and
 (b) they may affect the undertaking's ability to rely on relationships needed in its business processes on acceptable terms.

51. The **materiality** of **risks** and **opportunities** is assessed based on a combination of the likelihood of occurrence and the potential magnitude of the **financial effects**.

Application Requirements

Assessment of financial materiality

AR 13. The following are examples of how impacts and **dependencies** are sources of **risks** or **opportunities**:

- (a) when the undertaking's **business model** depends on a natural resource – for example water – it is likely to be affected by changes in the quality, availability and pricing of that resource;
- (b) when the undertaking's activities result in negative impacts, e.g., on local communities, the activities could become subject to stricter government regulation and/or the impact could trigger consequences of a reputational nature. These might have negative effects on the undertaking's brand and higher recruitment costs might arise; and
- (c) when the undertaking's business partners face material sustainability-related risks, the undertaking could be exposed to related consequences as well.



AR 14. The identification of **risks** and **opportunities** that affect or could reasonably be expected to affect the undertaking's financial position, financial performance, cash flows, access to finance or cost of capital over the short-, medium- or long-term is the starting point for **financial materiality** assessment. In this context, the undertaking shall consider:

(a) the existence of **dependencies** on natural and social resources as sources of **financial effects** (see paragraph 50);

(b) their classification as sources of:

i. risks (contributing to negative deviation in future expected cash inflows or increase in deviation in future expected cash outflows and/or negative deviation from an expected change in capitals not recognised in the financial statements); or

ii. opportunities (contributing to positive deviation in future expected cash inflows or decrease in deviation in future cash outflows and/or positive deviation from expected change in capitals not recognised in financial statements).

AR 15. Once the undertaking has identified its **risks** and **opportunities**, it shall determine which of them are material for reporting. This shall be based on a combination of (a) the likelihood of occurrence and (ii) the potential magnitude of **financial effects** determined on the basis of appropriate thresholds. In this step it shall consider the contribution of those risks and opportunities to financial effects in the short-, medium- and long-term based on:

(a) **scenarios/forecasts** that are deemed likely to materialise; and

(b) potential financial effects related to **sustainability matters** deriving either from situations with a below the "more likely than not" threshold or assets/liabilities not, or not yet, reflected in financial statements. This includes:

if. potential situations that following the occurrence of future events may affect cash flow generation potential;

ii. capitals that are not recognised as assets from an accounting and financial reporting perspective but have a significant influence on financial performance, such as natural, intellectual (organisational), human, social and relationship capitals; and

iii. possible future events that may have an influence on the evolution of such capitals.

