FAQ - Explaining Materiality in Corporate Reporting

This FAQ offers a high-level explanation of the materiality definitions and terms used in some of the standards and frameworks commonly applied in corporate reporting: financial reporting, sustainability reporting, and the integrated report.

Why is materiality important in corporate reporting?

Transparency, and by implication effective, complete and balanced reporting, is a cornerstone of good governance. Materiality is a critical element of reporting because it is a 'filter' for the matters and information to disclose in reports. Materiality determines what is most important to disclose - 'what matters most' as the saying goes. When materiality is inappropriately applied it may result in too much, too little or non-disclosure of information.

How is materiality determined?

The organisation's leadership is responsible for determining the material matters and material information to disclose. Materiality is informed by the organisation's unique circumstances; the industries, sectors and geographies in which it operates; the value chain and impacts of its products, services and waste on the economy, society and environment over time; the needs, interests and expectations of stakeholders; and other factors. The materiality determination and prioritisation process considers both quantitative and qualitative information and often requires a degree of judgement, and hence disclosure of the process is expected.

Importantly, determining materiality is guided by the standards and frameworks the organisation applies in its various reporting areas. This is critical because different standards and frameworks have different perspectives on materiality and thus different definitions (the definitions reflect the standard-setter's specific mandate and purpose). All the standard-setters have developed additional guidance to assist organisations in determining what is material to disclose in accordance with their standard. While the definitions may vary there are, however, some overall approaches, namely: 'financial materiality', 'impact materiality' or 'double materiality' (which encompasses both). Other popular terms are 'outside-in' and 'inside-out'. Also, 'financial materiality' is sometimes called 'single materiality'.

Note that the main standard-setters have recently issued[1], or are currently working on, interoperability guidance covering the common and incremental reporting disclosures between their standards.

How is materiality approached in financial reporting?

The International Accounting Standard Board (IASB) issues the International Financial Reporting Standards (IFRS Accounting Standards) used in financial reporting by organisations in over 140 countries. The alternative accounting standards are from the Financial Accounting

[1] EFRAG and IFRS Foundation, *ESRS-ISSB Interoperability Guidance*, May 2024; EFRAG and GRI, *GRI-ESRS Interoperability Index*, November 2023

Standards Board (FASB) and are predominantly used in the United States. The purpose of the IFRS Accounting Standards is to meet the information needs of investors and capital markets (stock exchanges and the like). The IFRS Accounting Standards take the **'financial materiality'** approach and define material information as: *"Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity"*[2] (the primary users being investors, lenders and capital markets).

How is materiality approached in sustainability reporting?

It's important to know that not all the popular sustainability reporting standards and frameworks have the same perspective on materiality - this is because they have different mandates and aim to meet the information needs of different stakeholders (broadly, this is either investors or multi-stakeholders including investors). The past few years have seen a step change in sustainability reporting with the formation of the International Sustainability Standards Board (ISSB) as the sister body of the IASB above. The ISSB Standards are similarly designed for investors relevant for their decision-making over the short, medium and long term. The ISSB is positioning its standards as a 'global baseline' for sustainability reporting to investors, which can be complemented by other sustainability reporting standards and frameworks that meet multi-stakeholders' needs[3]. Some of the standards are covered below.

IFRS Sustainability Disclosure Standards (ISSB Standards)

The ISSB issued its inaugural two standards in June 2023. The ISSB Standards take the **'financial materiality'** approach, using the same definition as the IFRS Accounting Standards above. The ISSB Standards require an organisation to disclose "*material information about the sustainability-related risks and opportunities that could reasonably be expected to affect the entity's prospects*"[4] - this is called sustainability-related financial information. There are prescribed guidance sources (as well as other sources which may be referred to) in identifying the organisation's material sustainability-related risks and opportunities and the related material information for investors. Disclosure includes the current and anticipated financial effects of the sustainability-related risks and opportunities on the organisation's financial position, financial performance and cash flows.

The ISSB Standards focus on the 'outside-in' view - that is, the inward-facing sustainability risks and opportunities that can affect the organisation's prospects, for example climate change, water, biodiversity loss and human rights. Importantly, the ISSB Standards only regard the organisation's impacts on society, economy and environment as material if they could have a financial effect on the organisation over the short, medium and long term[5].

GRI Standards

The GRI (Global Reporting Initiative) issued its first guidelines in 2000 and, today, the GRI Standards are the most widely used sustainability disclosure standards. The GRI Standards take the **'impact materiality'** approach and enable organisations to provide their impacts information to multi-stakeholders including investors.

[2] IFRS Accounting Standard *IAS 1 Presentation of Financial Statements*

[3] As well as local jurisdictional reporting needs.

[4] ISSB Standards, *IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information*, paragraph 17 and see paragraphs 17-19 and Appendix 1B B19-28

[5] Note that the contrary view to this is that most sustainability risks and impacts can affect financial performance at some stage and hence be of interest to medium and long term investors.

The GRI Standards require disclosure of the sustainability topics "*that represent an organisation's most significant impacts on the economy, environment and people including impacts on their human rights*"[6]. In the GRI's materiality determination process, the starting point is to identify the impacts (actual and potential, positive and negative) that the organisation's activities and business relationships can have on the economy, environment and people given the organisation's context (the process considers all impacts including operational, reputational or financial)[7].

The GRI Standards focus on the 'inside-out' view. The organisation's impacts encompass those directly caused or contributed to by the organisation in its own operations, products or services, as well as impacts which are otherwise directly linked to the organisation's upstream and downstream value chain.

European Sustainability Reporting Standards (ESRS Standards)

The ESRS Standards are regional mandatory sustainability reporting standards adopted by the European Union in July 2023 to support the implementation of the Corporate Sustainability Reporting Directive (CSRD). Important to note is that the ESRS Standards apply to organisations in the EU as well as non-EU organisations with EU operations meeting set criteria. The ESRS Standards take the **'double materiality'** approach and are designed to address the needs of multi-stakeholders including investors. The material sustainability matters and related material information to disclose are determined by considering the current or potential financial effects on the organisation[8] ('financial materiality') or the organisation's actual or potential impacts on the environment and society[9] ('impact materiality') or both. This approach covers the organisation's material sustainability impacts, risks and opportunities.

The disclosure requirements of *ESRS 2 General disclosures* are mandatory for all organisations, whereas the 10 topic standards apply only if the topic is material as a result of the materiality determination process (however, if climate change is excluded then the non-materiality must be explained).

The inter-connectedness of 'financial materiality' and 'impact materiality' is the reason for the growing popularity of 'double materiality'. The two elements can't be isolated from each other because material impacts can cause material financial effects and risks for the organisation (including damage to reputation and the 'social licence to operate').

How is materiality approached in the integrated report?

The integrated report is: *"A concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term"*[10]. It is often seen as the 'umbrella' report or 'head of the octopus' because it's the only report showing all aspects of the organisation.

[6] Extracted from *GRI 3: Material Topics 2021,* which is applicable to reports or materials published on or after 1 January 2023.

[7] Extracted from *GRI 1: Foundation 2021,* as applicable to reports or materials published on or after 1 January 2023.

[8] This aspect of materiality is aligned with the ISSB's financial materiality.

[9] This aspect of materiality is aligned with the GRI's impact materiality.

[10] *Integrated Reporting Framework*, page 10

In the *Integrated Reporting Framework*, materiality is one of the seven guiding principles: "*An integrated report should disclose information about* ***matters that substantively affect the organization's ability to create value over the short, medium and long term***"[11]. Value is defined as "*the process that results in increases, decreases or transformations of the (six) capitals caused by the organization's business activities and outputs"*[12].

The determination of materiality includes consideration of the organisation's unique circumstances; its external environment factors; the needs, interests and expectations of stakeholders; inputs and outcomes (impacts) on the six capitals over time; board and executive discussions; divisional reports; industry reports; and material events in the year. This materiality definition appreciates that the organisation's material matters will be of interest to providers of financial capital and other stakeholders. Integrated reporting's underlying concept of integrated thinking emphasises the inter-connectivity of the organisation's inputs from and consequential impacts on the six capitals over time.

The *Integrated Reporting Framework* is used by organisations in over 70 countries, and it can be seen as a 'global baseline' with the integrated reports in a country also prepared in response to local compliance requirements[13] (for example, see the section on King IV below).

In South Africa, how is materiality considered by King IV™ and the JSE Sustainability Disclosure Guidance?

King IV Report on Corporate Governance™ for South Africa 2016 (King IV)[14]

King IV™ is the widely used governance code for public and private organisations in South Africa. King IV's philosophy of sustainable development is based on its underlying concepts: integrated thinking, corporate citizenship, the organisation as a part of society, and stakeholder inclusivity. Its principles and practice recommendations are read in this context.

Principle 5 is: *"The governing body should ensure that reports issued by the organisation enable stakeholders to make informed assessments of the organisation's performance, and its short, medium and long-term prospects".* Some of Principle 5's practice recommendations are relevant to materiality and expect the governing body (board) to: Approve management's determination of the reporting frameworks to be used while considering legal requirements, intended audience and purpose thereof; Ensure the annual financial statements, sustainability reports, social and ethics committee reports or online printed information and reports comply with legal and regulatory requirements and/or meet the legitimate and reasonable information needs of key stakeholders; Approve management's bases for determining materiality for the purpose of deciding which information should be included in external reports; Ensure the integrity of external reports[15].

While King IV does not refer to a specific materiality approach, it can be strongly argued that in light of its underlying concepts it is based on **'double materiality'** rather than 'financial materiality' and hence covers disclosure of impacts on the economy, society and environment.

[11] *Integrated Reporting Framework*, 3D Materiality, page 29
[12] *Integrated Reporting Framework*, Glossary, page 54
[13] *Integrated Reporting Framework*, page 12
[14] Copyright and trademarks are owned by the Institute of Directors in South Africa NPC and all of its rights are reserved.
[15] Extracted from King IV, principle 5

This view is supported by various principles and practice recommendations. For example, Principle 3 states that *"the governing body should ensure that the organisation is and is seen to be a responsible corporate citizen"* and is based on organisational performance beyond financial and technical performance. It includes a practice recommendation for the governing body to *"oversee and monitor, on an ongoing basis, the consequences of the organisation's activities and output on its status as a responsible corporate citizen".* It provides further that oversight and monitoring should be performed against targets and indicators in respect of the workplace, economy, society and environment. Consequently, reporting in accordance with Principle 5 must by implication cover all areas of the organisation's performance, including those highlighted under Principle 3.

As King IV is the overarching governance code for the organisation and its board, its perspective guides the organisation's reporting.

JSE Sustainability Disclosure Guidance

This voluntary guidance was released in June 2022 by the Johannesburg Stock Exchange (JSE) and promotes the **'double materiality'** approach. It aims to improve the quality and availability of information for investors and other stakeholders. It is currently being updated.

Fitting it all together in your integrated report

The IRC *Information Paper: A global comprehensive corporate reporting system*, released in September 2023, outlines two approaches to structuring the corporate reporting suite. Both approaches centre on the integrated report with its integrated material matters and material information.

In preparing the integrated report, the organisation draws relevant information from a wide array of sources including the financial statements (with its 'financial materiality') and the sustainability reports and disclosures (using the GRI Standards, ISSB Standards, ESRS Standards or others with their unique materiality approaches). Importantly, the guiding force for preparing the integrated report is meeting the requirements of the *Integrated Reporting Framework* - that is, include the matters and information which are material to the organisation's ability to create value over the short, medium and long term, and this covers the positive and negative impacts on the six capitals over time.

Some resources on materiality

The list below is provided for informational purposes and is not intended to be considered as exhaustive. Please note that the IRC does not endorse, recommend or promote any of these resources (or their authors) at the exclusion of any other resource that may be available.

1. ESRS-ISSB Standards Interoperability Guidance, EFRAG and IFRS Foundation, May 2024
2. Double materiality. The guiding principle for sustainability reporting, GRI, 2024
3. GRI-ESRS Interoperability index, GRI and EFRAG, November 2023
4. EFRAG IG1 Materiality Assessment, May 2024
5. Preparing for the ISSB's sustainability disclosure standards Getting started: Materiality Deloitte (Australia), May 2023
6. Materiality in practice, Financial Reporting Council (UK), October 2023

7. The reality of materiality: insights from real-world applications of ESG materiality assessments, World Business Council for Sustainable Development (WBCSD), June 2021

May 2024

While every effort has been made to ensure the information published in this FAQ is accurate at the date of publication, the Integrated Reporting Committee (IRC) of South Africa, its members, Secretariat and the members of its Working Group take no responsibility (jointly or individually) for any loss or damage suffered by any person as a result of reliance upon the information contained herein.

Bibliography

1. *What you need to know about materiality in integrated reporting*, Alchemy Creative Studios. Date accessed 12 March 2024.
2. *What are ESG Materiality and Double Materiality? What you need to know,* VelocityEHS, 6 August 2022. Date accessed 12 March 2024.
3. *How materiality can help reporting meet the demands of investors*, EY, 24 August 2018. Date accessed 12 March 2024.
4. *Materiality in an integrated reporting setting: Insights using an institutional logics framework*, Cerbone and Maroun, The British Accounting Review 52 (3):100876, December 2019. Date accessed 12 March 2024.
5. Global preparers forum meeting, ISSB, 3 March 2023. Date accessed 12 March 2024.
6. *WBCSD CFO Network: Implementation Guidance for the International Sustainability Standards Board (ISSB) Standards and the European Sustainability Reporting Standards (ESRS)*, WBCSD CFO Network, 2023. Date accessed 12 March 2024.