

# The Materiality Report

Aligning Strategy, Performance and Reporting



November 2006



In association with

# The Materiality Report

---

The Materiality Report was produced by AccountAbility in association with BT Group and Lloyds Register Quality Assurance (LRQA). It was written and developed by Maya Forstater, Simon Zadek, Deborah Evans, Alan Knight, Maria Sillanpää, Chris Tuppen and Anne-Marie Warris.

Deborah Evans is Business Manager – Corporate Reporting and Assurance at LRQA  
[debbie.evans@lrqa.com](mailto:debbie.evans@lrqa.com)

Maya Forstater is a Senior Associate of AccountAbility  
[maya@accountability21.net](mailto:maya@accountability21.net)

Dr Alan Knight is Head of Standards and Related Services at AccountAbility  
[alan@accountability21.net](mailto:alan@accountability21.net)

Maria Sillanpää is a Senior Associate of AccountAbility  
[maria@accountability21.net](mailto:maria@accountability21.net)

Dr Chris Tuppen is Head of Sustainable Development and Corporate Accountability at BT  
[Chris.tuppen@bt.com](mailto:Chris.tuppen@bt.com)

Dr Anne-Marie Warris is Global Product Manager – Environment at LRQA  
[anne-marie.warris@lrqa.com](mailto:anne-marie.warris@lrqa.com)

Dr Simon Zadek is Chief Executive of AccountAbility  
[simon@accountability21.net](mailto:simon@accountability21.net)

The Materiality Framework is based on the approaches and experiences of businesses including Anglo American, BP Plc, BT Group Plc, Ford Motor

Company, The Gap Inc., Hydro Tasmania, Nike Inc, Novozymes and Telefonica. We are grateful for the insights provided by Karin Ireton of Anglo American; David Bickerton, Adriana Mazry and Nicholas Robinson of BP; Susan Morgan of BT; Dunstan Hope of BSR; Krista Gullo and Andy Hobbs of Ford; Lucy Candlin of Future Perfect; Darryl Knudsen and Monica Oberkofler of Gap; Sean Gilbert of GRI; Alison Howman of Hydro Tasmania; Charles Gatchel of Nike; David Owen of Nottingham University; Claus Frier and Pia Carlé Bayer of Novozymes; George Dallas of Standard and Poor's; Susan Todd of Solstice Sustainability Works; Rafael Fernandez Conazon of Telefonica; and Lars-Olle Larsson (independent).

Jeannette Oelschlaegel, Eric Ripley and Meera Shah from the AccountAbility team also contributed to the development this report and Alex Chilton of Alex Chilton Design was responsible for its design.

**Download this report, as well as further resources on materiality from**  
<http://www.accountability21.net/materiality>

**AccountAbility**  
250-252 Goswell Road, London  
EC1V 7EB United Kingdom  
+44 (0) 20 7549 0400

November 2006  
ISBN 1-901693-41-4  
© AccountAbility, BT Group Plc and LRQA, 2006.  
All rights reserved.

## Foreword

---

As three organisations involved in sustainability reporting we have, in different ways, seen the concept of materiality become an increasingly important word in the reporting lexicon.

There are two challenges facing reporters. One is to find an approach that provides the comprehensive data that some stakeholders require, while still being able to show what's really important to the success of the organisation. The second is to do this in a concise and clear way. A successful materiality determination process is key to meeting these challenges.

In this report we have explored the concept of materiality, reviewed how various companies have tackled it and propose a Materiality Framework that everyone can use.

As we travelled this journey it became increasingly clear to us that the benefits of a robust materiality determination process go far beyond reporting. It provides the organisation with evidence that links sustainability to commercial strategy, helps identify longer term value drivers and is a route to the convergence of sustainability and the market place.

Ultimately we believe a greater emphasis on materiality in sustainability reporting will lead to an accelerated convergence with financial reporting.

This is an exciting, experimental space please share your thoughts and experience with us.



**Simon Zadek**  
AccountAbility



**Chris Tuppen**  
BT Group Plc.



**Deborah Evans**  
LRQA

# Contents

---

<b>Foreword</b> .....	<b>3</b>	<b>5. Materiality Futures</b> .....	<b>47</b>
<b>In Brief</b> .....	<b>5</b>	Clarity and transparency of criteria and thresholds	
<b>Introduction</b> .....	<b>7</b>	Stretching the horizons of decision making	
<b>1. The Business of Sustainable Development ...</b>	<b>9</b>	Materiality at the margins of corporate control	
Knowing what counts		Linking material issues with information requirements	
Sustainability is a business imperative		Evolving Assurance	
The counting revolution			
The problem with ‘non-financial’ reporting			
<b>2. Materiality and Strategic Alignment</b> .....	<b>13</b>	<b>6. Conclusion</b> .....	<b>51</b>
What counts for the long-term?			
What counts to people who can influence success?			
Redefining materiality			
Delivering on materiality			
<b>3. The Practice of Materiality</b> .....	<b>20</b>		
An emerging common approach			
Developing a filter to prioritise issues			
Embedding sustainability thinking			
Focused on reporting, but aiming at performance			
Standardised, but not mechanised			
The integration challenge			
How good is leading practice?			
<b>4. The Materiality Framework</b> .....	<b>31</b>		
Part A: Working definition of materiality			
Part B: Design principles for materiality determination processes			
Part C: Implementation questions			
Part D: The core process			

## In Brief

**The challenge of sustainable development requires business to shift from viewing it as a matter of compliance to one of value generation.**

The most important contribution of businesses to social and environmental challenges will be in *what they do* in achieving success rather than *what they avoid doing*. To achieve this, businesses will need to align strategies and performance management to emerging social and environmental constraints and opportunities.

**Businesses need to work out what is material, and articulate this in credible ways in order to drive learning and innovation.**

Most businesses, and their investors, however, remain unclear as to which issues might turn out to be critical to long-term success. Today's practices for determining financial materiality only capture information relevant to short-term performance and risks.

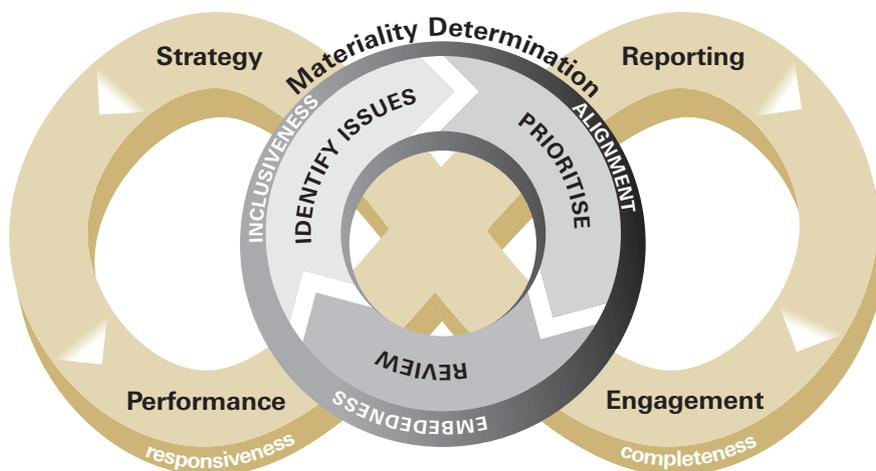
**Leading businesses have begun to develop robust yet practical approaches for determining**

**materiality in the context of sustainability reporting.**

The emerging common approach is based on a combination of stakeholder engagement, understanding of environmental limits and strategic alignment. It has made the process, assumptions and evidence base for identifying material issues more transparent, credible and amenable to both debate and assurance.

**A generally applicable Materiality Framework has now been developed which can be used by other businesses to help align their strategy to emerging social and environmental constraints and opportunities.** It enables:

- ❖ **Business leaders and managers** to better understand how emerging sustainable development issues could be integrated into, thus driving business strategy and performance.
- ❖ **Communicators and assurance providers** to ensure that sustainability performance report-



---

ing focuses on material issues and enhances the value of both reporting according to leading reporting and assurance standards such as the AA1000 Assurance Standard, GRI G3 Guidelines and ISAE3000, as well as more traditional financial and governance and risk-related reporting.

- ❖ **Stakeholders** to better understand and influence how businesses are aligning or can align their strategies and performance with sustainability issues.

**While businesses can initially use the Materiality Framework to help rationalise external communications, it has the power to close the loop between reporting and stakeholder engagement on one side, and strategy development and performance management on the other.**

**Approaches to materiality will need to evolve as their application is stretched beyond sustainability reporting to mainstream accounting and**

**reporting, strategy development and performance management.**

- ❖ More clarity about the specific criteria and time horizons that businesses use in determining materiality would facilitate analysis of their approach to emerging social and environmental opportunities.
- ❖ More sophisticated assessments of user information needs would help to strengthen the quality and usefulness of reporting and assurance.

**Widening the focus of materiality is the means by which the basis of mainstream financial assurance and reporting can absorb, or be absorbed into, the sustainability agenda.**

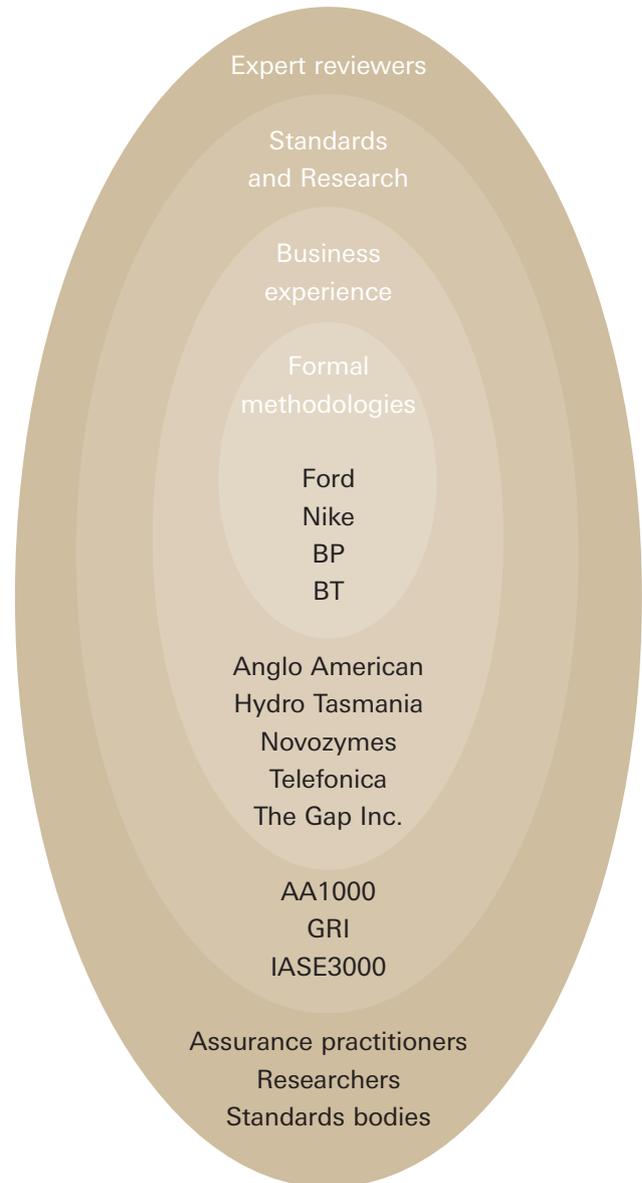
# Introduction

This report seeks to promote a closer alignment between business strategy, performance management and reporting. It draws on the experience of pioneering businesses in developing a rigorous yet practical approach to determining what could be material to their long-term success. At its heart is a generally applicable Materiality Framework which can be used to:

- ❖ **Understand the alignment** between sustainable development issues and business strategy.
- ❖ **Develop corporate reports** and broader communication and engagement strategies that reflect active priorities of the business and its stakeholders.
- ❖ **Influence debates and strategy development** by identifying gaps between emerging areas of concern and current business strategy.

It will be useful to both business leaders and managers concerned with strategy and performance communicators and assurance providers concerned with reporting. The report is also a contribution to the wider ongoing debate about materiality in voluntary and investor-led reporting standards, listing requirements and other regulations governing reporting.

The report was produced by AccountAbility in association with BT Group and Lloyds Register Quality Assurance (LRQA). It is based on the approaches and experiences of businesses including Anglo American, Ford Motor Company, The Gap Inc., Hydro Tasmania, Nike, Novozymes, BP Plc, BT Group Plc and Telefonica. Leading thinkers and practitioners from the world of reporting, assurance and standards development commented on various drafts.



Direct quotes from interviewees are shown in blue throughout the report.

As with many areas of innovation, there is a tension between the desire to provide practical guidelines

---

and to encourage experimentation. In this report we try to do both. Chapter 1 makes the case for a more strategic approach to sustainability issues. Chapter 2 introduces the concept and practice of materiality. Chapter 3 drills down into the experience of our case study companies to extract the crude oil of leading practices while Chapter 4 refines this into a Materiality Framework which can be used to drive performance and learning in other organisations. Chapter 5 highlights key challenges and Chapter 6 sets out the agenda for further development by businesses, standards bodies, assurance providers, research institutions and policy makers.

Understanding materiality is important for all organisations seeking to ensure that their long-term objectives are not pushed off course by short-term targets. Although this report focuses on the challenges and experience within the private sector, many of the concepts and processes will be transferable.<sup>1</sup>

# 1. The Business of Sustainable Development

This chapter outlines why the concept and practice of materiality is crucial for marrying long-term business success with sustainable development. It outlines the need for robust materiality processes to underpin credible and useful information flows, and ultimately drive corporate performance and change.

## Knowing what counts

Business success depends on the ability to understand, respond to and shape the competitive environment. In the face of rapidly changing societal, environmental, competitive and regulatory pressures, businesses need to be open to learning from diverse sources. Yet, they also need to be able to differentiate what is material from what is 'noise'.

*Material issues are those things that could make a major difference to an organisation's performance*

Markets evolve and the drivers of value shift. Things that definitely did not count yesterday may make or break an organisation today; what might be important today may turn out to be irrelevant tomorrow. For example, a decade ago, raising the topics of obesity, nanotechnology or 'the fortune at the bottom of the pyramid' as business issues, would have drawn a blank face from all but the most prescient.<sup>2</sup>

Businesses therefore need to know what counts. The adage, 'what gets counted, counts' is a back to front view. A more realistic mantra for managers to keep in mind is that 'what counts needs to be counted'. Only

then can it be better understood and managed, which in turn requires it to be effectively communicated inside the organisation and to external stakeholders.

*Material information provides the basis for stakeholders and management to make sound judgements about the things that matter to them, and take actions that influence the organisation's performance.*

## Sustainability is a business imperative

The challenge of sustainable development requires business to shift from viewing it as a matter of compliance to one of value generation. As business rises to the challenge, its most important role will be in *what it does*, not what it is *what it avoids doing*. Delivering transformative products and services to low-income consumers, for example, will not happen through compliance. Addressing global health challenges will need new business models, as will our food production and energy supply systems.

*"Don't do it as a reputation-management tool: Do it because it genuinely contributes to your business strategy."*

Hannah Jones,  
Vice President  
for Corporate  
Responsibility, Nike<sup>3</sup>

Sustainable development requires business to do more, faster and better, not to do less, or be solely guided by 'doing no harm'.

Some leading businesses are beginning to view the way they address social and environmental issues as a driver of business success. General Motors for example has long been a supporter of workplace diversity through both internal hiring practices and external relationships.

Its commitment to workplace diversity is a core part of its strategy to appeal to its diverse consumer base. Volvo, on the other hand, strives to take a lead in the development and implementation of safety technology.<sup>4</sup> This does not mean that GM ignores product safety or that Volvo does not uphold standards of equal opportunity, but that they have sought to lead the field in specific areas aligned to their brand proposition. Some firms are also grasping how sustainable development issues could strengthen or undermine the very foundations of their business. Anglo American Plc, for example, recognises that HIV/AIDS is a strategic threat to their operations. Providing medication to employees and their families and even surrounding communities is not just a humanitarian impulse but a business response.

These days there is not a single clear threshold of legal, financial or reputational liability below which businesses can safely say “that is not our problem”. Emerging issues are contested and difficult to measure, but can be early warning signs of growing risk, or opportunities to gain a competitive advantage. More established issues become an accepted part of doing business. But whether they are seen as costs or value drivers depends on the business response. Businesses that take leadership in addressing the digital divide might well gain product insights and major public contracts. Apparel companies that fix their labour standards may be well placed to reap crucially important productivity gains by accelerating their adoption of lean manufacturing techniques. But only if sustainable development and strategy are aligned.

## The counting revolution

Businesses seeking to align their response to social and environmental challenges to their business strategy, or indeed to reinvent their business model, need to be able to communicate this to their investors, and to other stakeholders who can influence their success.

The global rise in corporate responsibility reporting is one sign of how businesses are seeking to come to grips with their environmental and social performance.

*Number of top 100 companies reporting on corporate responsibility in different regions:*

*90 Europe  
59 USA  
61 Rest of world<sup>6</sup>*

Corporate responsibility reporting is now a majority practice amongst the world’s largest businesses. It is not limited to major publicly quoted companies either: suppliers within global supply chains are increasingly required to show evidence of their social and environmental impacts. In this way, millions of small and medium sized businesses all over the world are already reporting on their social and environmental performance.<sup>6</sup>

The financial audit community has sought to innovate new forms of reporting, for example PriceWaterhouseCoopers’ *ValueReporting*<sup>®</sup> framework and a range of other tools developed to measure intellectual capital have all embraced some social and environmental issues. The ‘corporate responsibility’ movement, however, has outpaced these explicitly business-focused initiatives, generating an enormous number of standards and tools to measure, manage and report on the ‘big picture’.

*“Just producing this report proved to us that the value of reporting goes far beyond transparency. It becomes a tool for improving both our management of business and in giving us clues about what we need to do next.”*

Phil Knight,  
Chair of Nike, Inc.<sup>7</sup>

Prominent has been the GRI Guidelines, which have provided the world's first general sustainability reporting framework, along with a growing number of sector specific supplements.

Reporting of course is not an end in itself. It is only useful if it facilitates change. Studies show that public disclosure improves the management of those issues being described,

even those that are not yet reported on.<sup>8</sup> The fact that reporting puts social and environmental performance issues in the public domain keeps business on its toes. Indeed, some evidence suggests that the *process* of building a public report is the single most important driver of change in how things to be reported are managed, since it increases organisational knowledge, enables reflection and catalyses policies and practices.<sup>9</sup>

### **The problem with ‘non-financial’ reporting**

There is a real danger that reporting on social and environmental performance will become an exercise in compliance which contributes little to learning or innovation, with sustainability reports becoming bloated data-dumps.<sup>11</sup> Although online reporting relieves some of the burden of overweight reports, online data-dumps are no more useful than weighty printed tomes. The reporting function is becoming automated, driven mechanically by guidelines, management systems and databases. These tools

*Increased standardisation of reporting brings both risk and opportunity – opportunity to influence hundreds more companies than previously, coupled with risks in the form of lower rates of innovation.*

Sustainability/UNEP/  
Standard&Poor's<sup>11</sup>

on social and environmental impacts does not just take place solely within the context of ‘sustainability reports’. Risks associated with social and environmental performance are becoming integrated within risk analysis and mainstream reporting in accordance with ever-tougher regulatory requirements.

Every business understands that the way it responds to its changing environment is a key determinant of its financial success. They already apply this principle in some areas, such as looking after their employees and making sure that customers are satisfied with the service they get. But it is another matter when it comes to emerging social and environmental issues.

Most businesses are not at all clear, beyond the most obvious, traditional or regulated areas, which social and environmental issues are likely to be material to their business. Despite centres of knowledge in most large companies, it has proved hard to persuade business leaders to take emerging issues with the seriousness that they deserve, and in particular to

are needed of course, but without intelligent and focused application, data quickly loses its meaning.

The problem stems from cordoning all this management, measurement and disclosure under the ‘non-financial’ heading. This ignores the fact that growing aspects of social and environmental impacts *are* material to financial performance. Furthermore measuring and reporting

---

*“Although companies see the financial community as the key audience for their CR reports, the reports are often wholly inadequate for their needs. What analysts need is information and data that is material to a company’s business.”*

Mark Makepeace  
Chief Executive,  
FTSE Group<sup>12</sup>

see them as strategic opportunities to be grasped rather than risks to be managed.

Advocates for sustainable development within businesses are often within groups seen as peripheral to strategic development, such as environmental management or community affairs. If they have been brought in for their strong issue expertise they may lack a clear understanding of the factors driving a business’s

growth strategy. Often they are not taken seriously by those responsible for business strategy until it is too late, or at least until first-mover opportunities have been lost.

To make matters worse, advocates of social and environmental responsibility within or outside of businesses rarely know how to make the strategic case. Many still tend to focus first and foremost on proving the importance of an issue, and then argue that the issue should be taken seriously for reputational reasons. Since the debate fails to demonstrate how business performance can make the biggest difference in addressing social and environmental issues, most external stakeholders remain focused on compliance, while mainstream investors ignore these issues altogether because the business fails to demonstrate why they are important to business success.

Businesses need to work out what is material, and to articulate it internally and externally in credible ways in order to drive performance. A more rigorous and strategic approach to materiality offers the opportunity to close the loop between reporting and stakeholder engagement on one side and strategy development and performance management on the other. This would enable the emerging building blocks of responsible business practice to be linked together into a coherent learning and improvement cycle.

## 2. Materiality and Strategic Alignment

This chapter outlines how the concept of materiality needs to change in order to deliver information which is able to drive sustainable performance. In particular it highlights the need to focus on information user's real information needs and the time horizons that influence sustainability.

The concept of materiality emerged originally from the critical relationship between data-rich management and arms-length shareholders. For all the talk of stakeholders, this relationship is still what counts for the bulk of the business community.

More recently the idea has been pressed into service to try to assess the basis for reporting on a business' approach to wider social and environmental issues. Neither approach has proved effective in picking up on the drivers of long-term business transformation:

- ❖ **Accounting assessments of materiality focus too narrowly** on timescales, stakeholder interests and business actions that impact on short-term performance.
- ❖ **Stakeholder driven sustainability reporting** demands an ever-broader set of disclosure items focusing on business compliance, rather than opportunity.

Preventing fraudulent, illegal or immoral practices is obviously important. But, compliance, although important, is only one part of the equation.

Focusing the materiality lens on those sustainability issues that could drive business strategy and

performance is the most effective way both to drive and to test businesses' real commitment to the sustainability imperative. Businesses that deem issues to be immaterial that stakeholders consider important are revealed as not having an embedded response. Real business leaders, those who have 'got it', can be distinguished from those who are still primarily focused on avoiding problems.

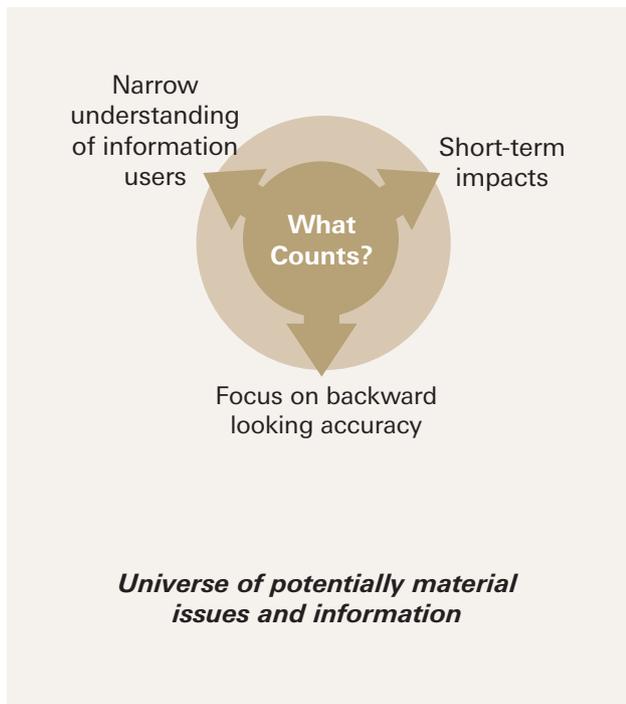
A new approach to materiality is needed to help businesses manage for the long-term, bridging the gap between the narrow focus of financial materiality and the wide lens of stakeholder inclusive reporting.

Traditional definitions of materiality focus on identifying information that might be useful to decision making (most often by investors). The **Financial Accounting Standards Board (FASB)** defines materiality as: *"the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgement of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."*<sup>13</sup>

Established 'rules of thumb' are often used as thresholds of materiality (although they increasingly challenged), for example data may only be counted as material if it relates to 5% or more of expected short-term net earnings. A similar approach to defining materiality has been adopted within some technical disciplines. For example, in the context of greenhouse gas emissions, the **EU Emission Trading Scheme (ETS)** has a broad guideline in which data that would change the total emissions figure by more than 5% would be considered a material misstatement or omission.<sup>14</sup>

Accountants and assurance providers have tended to focus on questions of materiality of *reported data* (its veracity, accuracy and completeness) rather than its scope, since the audience and the 'bottom-line' in these cases are seen as well defined.

### The Narrow Focus of Materiality



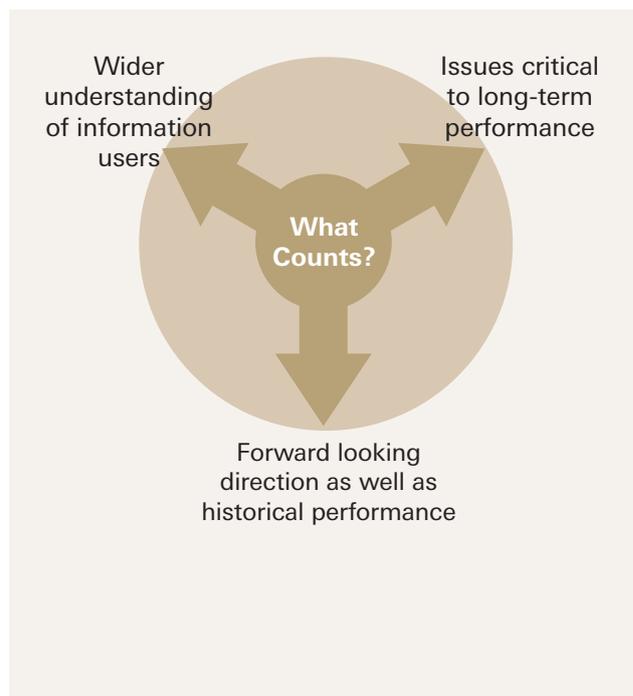
Sustainable development requires businesses, and investors, to think about *time* and *timeliness* in a different way. On one hand, it stretches planning horizons and commitments into the future, and on the other hand it opens the door to society's wider demands for outcomes from business to be delivered today, if not sooner.

Traditional assessments of financial materiality take an overly myopic view of what drives business performance. A new approach to materiality still

needs to focus on what is important *to the business*. But it needs to do this with a wider focus, in order to capture:

- ❖ A **longer term view of the issues** that could affect the success of its strategy;
- ❖ A **wider view of the people** whose actions influence performance, and who therefore need sound information to guide their judgments;
- ❖ A **deeper view of the information** necessary for sound decision making, including where necessary both financial and non-financial data, and forward as well as backward looking indications of performance.

### Widening the focus of materiality



---

## What counts for the long-term?

New approaches to determining what information is material need to be able to address stakeholders' requirements for both forward and backward looking perspectives, narrative reporting and comparable

*"It almost goes without saying that pension funds should invest for the long-term. Unfortunately, the current system of investment decision-making has much stronger management mechanisms for ensuring relative out performance over the short-term."*

Peter Moon, Chief Investment Officer, Universities Superannuation Scheme<sup>15</sup>

data with a level of accuracy and detail sufficient to inform decision making.<sup>16</sup>

The interests of the owners of capital, even when narrowly defined in exclusive financial terms, are not best served by the investment community's focus on short-term performance.

Tomorrow's successful businesses are likely to reinvent their underlying business models more than ever before. Yet today's accepted practices only capture information concerning activities that impact on short-term performance. The practice of assessing materiality in

terms of a 'hurdle' of financial value such as 5% of expected short-term net earnings reinforces an almost exclusive focus on short-term performance. Long-term investors betting on the prospective returns from firms with effective strategies and management are poorly served by current materiality thresholds.

Short-term performance measurement, it is argued by many in the investment community, offers the

best way to achieve long-term performance. Yet there are real questions as to whether this is the case. Researchers from Duke University, the National Bureau of Economic Research and the University of Washington concluded that companies regularly sacrifice opportunities for long-term value creation in their efforts to meet short-term investor expectations.<sup>17</sup>

Of course, companies have always reported on more than just the backward looking financial results within their mainstream financial reports. Management discussion provides critical information on forward looking plans and qualitative operational factors. Financial stakeholders, though inevitably interested in the figures on earnings, cash flows, assets and liabilities increasingly seek further insight into the factors underlying business performance.

Other stakeholders too seek more than a 'rear-view mirror' view of performance. Evidence of compliance with laws, norms, codes and commitments is crucial for those seeking to scrutinise past operations and penalise poor performers. But it is less useful to stakeholders with an interest in investing their trust and their financial or organisational capital in businesses that are innovating new solutions to social and environmental issues.

## What counts to people who can influence success?

Businesses need to understand what counts to the people who can influence their success. They need to report on their performance in ways that respond to and influence significant stakeholders. Therefore a new approach to materiality needs to be able to be based on an understanding of what issues are impor-

*“The relations that a company has with its key stakeholders can be critical to its own long-term financial and operational sustainability — and not just that of society more broadly.”*

George Dallas,  
Managing Director,  
Standard and Poor’s<sup>18</sup>

tant to different stakeholders and information users.

Today’s business value is as much rooted in relationships as it is in technological prowess or engineering excellence. Stakeholders are not just passive observers of business practice, they are actively engaged in trying to change what is material to the businesses bottom line. For example, advocates of anti-corruption

have advanced the law, policies and practices in ways that have turned ‘acceptable ways of doing business’ involving illegal transactions into a growing liability. Environmentalists, increasingly working with business, have turned the spectre of climate change into material risks and opportunities across markets. Campaigns against financial institutions’ failure to apply social and environmental criteria to cross-border project investments has led to the emergence of a set of banks that see their association with the Equator Principles as a source of material competitive advantage.

Businesses need to communicate on their social and environmental performance to diverse stakeholders either through formal performance reports, or targeted or responsive communication with investors, staff, customers, policy makers and NGOs. UK retailer, Marks & Spencer for example has recently reduced the number of key performance indicators it reports on in its sustainability reports – focusing on issues of strategic importance to the

business. At the same time it launched the ‘Look Behind the Label’ initiative to communicate to customers about the subset of issues that matter most to them.

### **Redefining materiality**

New reporting and assurance standards have an approach to materiality, which takes in stakeholder concerns but focuses them on how they could relate to business performance. The Global Reporting Initiative guidelines position materiality as a crucial principle for deciding what issues and indicators to include, omit, or emphasize in sustainability reporting. The latest ‘G3’ version puts as much emphasis on the underlying principles of inclusivity, materiality and completeness as it does on the menu of standard disclosure items.

AccountAbility is the steward of a sustainability assurance standard, the AA1000 Assurance Standard (AA1000AS)<sup>19</sup>. AccountAbility’s approach to materiality draws heavily from the financial audit community, but extends the basis of accountability beyond the investor to embrace a far-wider range of impacted stakeholders. In its ‘5 part materiality test’ it calls on businesses to identify issues that are relevant to:

- ❖ Direct short-term financial performance;
- ❖ The company’s ability to deliver on its strategy and policies;
- ❖ Best practice norms exhibited by peers;
- ❖ Stakeholder behaviour and concerns; or
- ❖ Societal norms, particularly where linked to possible future regulation.

However, while both AA1000AS and the GRI call for businesses to identify and prioritise material issues,

there is currently little guidance on prioritisation. The Materiality Framework described in this report fills the prioritisation gap in both the AA1000 and GRI standards.

The International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) have produced a beta version of a non-financial assurance standard (ISAE3000). It seeks to blend the financial auditor's traditional approach to defining materiality with elements of broader 'stakeholder defined' inputs. Crucially, it opens the door to allowing 'eligible criteria', the things to take into account during the assurance assignment, to be determined by third party initiatives such as the metrics set out in the GRI Guidelines.<sup>20</sup>

*“Why not spend the next four decades making our trucks, refrigerators, stores, lighting, packaging, shipping – every aspect of our business - the most productive in the world? This will be good for the environment, it will save us money, and in some cases, it will actually add profits to our bottom line.”*

Lee Scott, CEO, Wal-Mart<sup>21</sup>

In determining materiality aligned to long-term business success, businesses need to be able to identify what is important to stakeholders, and what therefore might be important to the business. But they also must be able to narrow these issues down in order to identify, develop and communicate how they intend to align social and environmental issues with their strategy, practices and ultimately performance.

This means recognising that not everything that people think is important is

**The AA1000 Assurance Standard** requires:

*“that the Assurance Provider states whether the Reporting Organisation has included in the report the information about its sustainability performance required by its stakeholders for them to be able to make informed judgments, decisions and actions.”*

**Materiality in AA1000 and the GRI**

**The Global Reporting Initiative G3**

**Guidelines'** 'materiality' principle has been revised to cover both significance of impacts and information requirements of stakeholders: *“The information in a report should cover topics and indicators that reflect the organisation's significant economic, environmental, and social impacts or that would substantively influence the assessments and decisions of stakeholders.”*

The G3 guidelines require that the report prioritise material topics and indicators, but recognises that the methods or processes used for assessing materiality will need to be defined by each organization .

In G3, the quality of information is also covered by a separate principle of 'accuracy': However, this is related back to the materiality of information to information users: *“The specific threshold of accuracy that is necessary will partly depend on the intended use of the information.”<sup>22</sup>*

---

material. Whether Wal-Mart uses Fairtrade coffee in its staff canteens is certainly important to the Fairtrade movement, to its coffee suppliers and to some of the firm's employees. But it is highly unlikely that this matter is material to Wal-Mart. On the other hand, although Wal-Mart's position on its environmental impact started from a defensive posture, it has become increasingly integrated into its strategic thinking. The decision to invest \$500 million a year in energy efficiency improvements is now a core part of its overall strategy for driving down costs.

Neither is materiality just about the size or cost of the activity in question, nor is it about the overall importance of the issue to society. Ford's 87 million dollar support for a breast cancer charity over the past 12 years is not considered material since it is not aligned to its business strategy. Its much smaller sponsorship of the World Business Council for Sustainable Development's Sustainable Mobility Project might well turn out to be material, if it can help the business address the challenge of how to grow its business in the long-term.

Accepting that some stakeholders' concerns are not important at a strategic, corporate level is unpalatable to many in civil society, who see it as a move away from the stakeholder focus of sustainability reporting and an overemphasis on business opportunities and risks. However, it is a crucial step towards rooting sustainable development within companies' business models rather than letting it remain a side issue.

Businesses will still need to disclose their performance with respect to laws, commitments and voluntary initiatives where they have identified a compliance responsibility or an area of information

demand. But they should put clear emphasis on the issues that are critical to their strategic goals. This is where their efforts to manage social and environmental performance will have the greatest impact. And it gets to the heart of what stakeholders want to know: *how seriously is this business taking the issues that matter to me?* If the honest answer is 'not very seriously' this is as much useful information as are pages of indicators.

### **Delivering on materiality**

So businesses need a simple, yet robust framework for determining materiality. Emerging standards offer welcome and useful islands of clarity in working out what counts in relation to particular issues.

*"While everybody seems to be talking about materiality, its definition is very foggy. And if its definition is foggy, then guidance on its practical determination is positively opaque. Perhaps this is why a number of companies have gone it alone and have started to develop their own approaches."*

Chris Tuppen,  
Head of Sustainable  
Development,  
BT Group Plc<sup>23</sup>

However, businesses will never be able to completely outsource their understanding of materiality to these wider societal dialogue processes because what is material depends on the particular company and its evolving business strategy.

Such a framework must be useful first and foremost for the organisations that create the impacts, seek to manage their performance, and look to communicate effectively with their stakeholders. It also needs to be something that assurance providers use in assessing reporting quality. Finally, it needs to be communi-

---

cated to stakeholders themselves, so that they can better understand the basis of an organisation's strategy and performance.

The following chapter sets out the approaches and experience of some of the leading businesses that have begun to develop rigorous and strategic approaches to materiality.

## 3. The Practice of Materiality

---

This chapter explores the experience of leading businesses in developing workable approaches to assessing materiality in order to draw out the common elements and key challenges.

### An emerging common approach

In describing the way in which they had gone about determining materiality, interviewees outlined processes which covered three key stages; **identify issues, prioritise** and **review**. They also reflected on crucial enablers that underpinned their practices, in particular **competencies** and **governance**. Finally they emphasised the need to lock materiality into their **assurance** processes.

While there were a number of detailed differences in approaches taken by different firms, the central similarities seem to indicate an emerging common approach. Some of the details remain proprietary information.

### Developing a filter to prioritise issues

The interviewees found that existing mechanisms such as their ongoing stakeholder engagement, AccountAbility's Five-Part Materiality Test, standards such as the GRI Guidelines and peer benchmarking were all useful in identifying issues, but what they needed as a next step was a robust and usable framework for determining the strategic significance of different issues.

Businesses prioritised issues through a process of internal reflection and analysis. Some used an informal, iterative approach, based on key principles.

*"We're not looking to make it too formalized. When we are working with these issues, we are looking at issues that are relevant to us and to our stakeholders. In our Novozymes mission and value statement, we have specifically listed that stakeholder dialogue is an important way of working for Novozymes."*

Claus Frier, Novozymes

*"We've had an organic, iterative process - it hasn't been a linear case of start here, define our universe of materiality then go out and engage. More like we engage with stakeholders on one piece of the process then step back and look at the big picture and reflect on the choices we've made. Then we may correct our course along the way."*

Darryl Knudsen, The Gap Inc.

Others developed more formal systems. These were variations on the familiar matrix plots used in risk analysis, but with scales representing societal and business significance. Issues were systematically assigned to numerical or descriptive scales and then plotted graphically to show where they lay in relation to prioritisation criteria.

Potentially material social and environmental issues occupy the contested area where neither legal nor financial guidance thresholds are sufficient. Businesses therefore have developed their own prioritisation criteria and thresholds to assess materiality in the context of managing for long-term sustainability.

Different businesses employed a combination of slightly different measures for each axis. For example BT and Ford's formal prioritisation issue rating criteria are listed below.

BT's prioritisation criteria	Ford's prioritisation criteria
<ul style="list-style-type: none"> <li>❖ Does BT have a policy on this issue?</li> <li>❖ What is the financial impact of the issue on BT?</li> <li>❖ Are stakeholders interested in this issue?</li> <li>❖ Is there societal interest in this issue?</li> </ul>	<ul style="list-style-type: none"> <li>❖ Those issues that have significant current or potential impact on the company</li> <li>❖ Those issues that are of significant concern to stakeholders</li> <li>❖ Those issues over which Ford has a reasonable degree of control</li> </ul>

While all companies were trying to simultaneously assess issues for corporate and stakeholder significance, there were key differences in their approach:

- ❖ **Interest or impact rating?** Some businesses rated issues according to the level of stakeholder interest or concern (for example determined through stakeholder research and media monitoring), while others looked at the issues themselves and rated them according to the level of impact their activities have on the planet and the importance and urgency of the issue in absolute terms. Others used a combination of these approaches.
- ❖ **Risk based or opportunity based criteria?** The matrix tool often used as the basis for prioritisation is adapted from a risk-analysis framework. Some of the companies have tried to capture opportunities within their matrix. However the standardised filtering of issues using existing strategies, risk analysis and regulatory disclosures on one hand and stakeholder complaints and compliance demands on the other, more readily identifies risks. The ability to capture emerging opportunities within the framework is particularly dependent

on the competencies of its implementers and their understanding of and influence on the company's business strategy.

- ❖ **Measured, numerical or descriptive scale?** Some companies have assigned a numerical scale to their analysis while others display a high/medium/low scale. In fact, the biggest difference is not between approaches that use numbers and those that do not, but between those that attempt to measure quantitative values such as revenue implications, financial liability or size of risk or those where the numbers are scores to represent and combine more qualitative judgements about risks and opportunities.

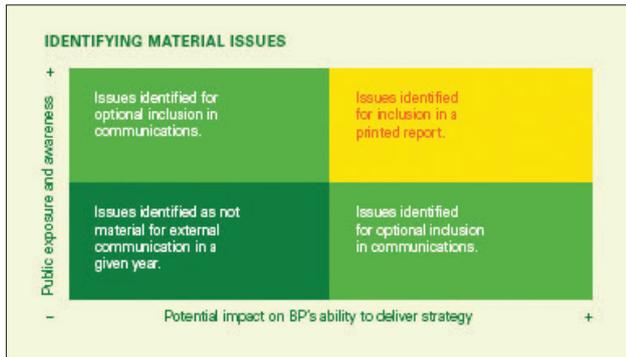
The choice of rating criteria is an important one. Standardised rating approaches based on scores linked to particular items of evidence demanded less specialist knowledge and produced more clearly replicable results. However more qualitative approaches were able to identify opportunities or capture and stimulate debate and learning.

*“We decided that a high/medium/low scale was enough to capture good management judgements about the level of risk and significance to attach to an issue. But we also needed to make people internally more comfortable with the idea that not quantified does not mean not real.”*

Karin Ireton, Anglo American

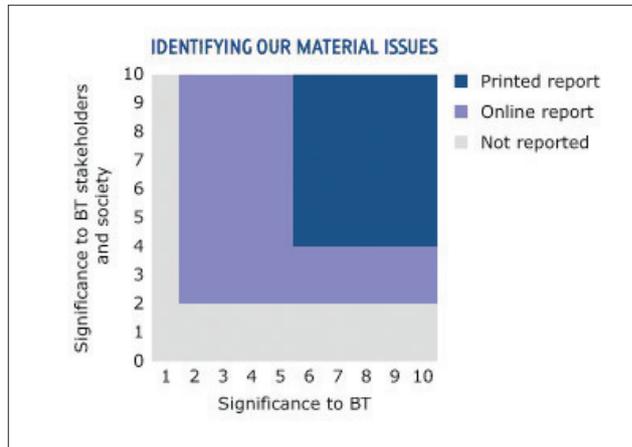
Issues were plotted on graphs and divided into zones indicating whether they were considered material or not.

### BP’s Materiality Matrix

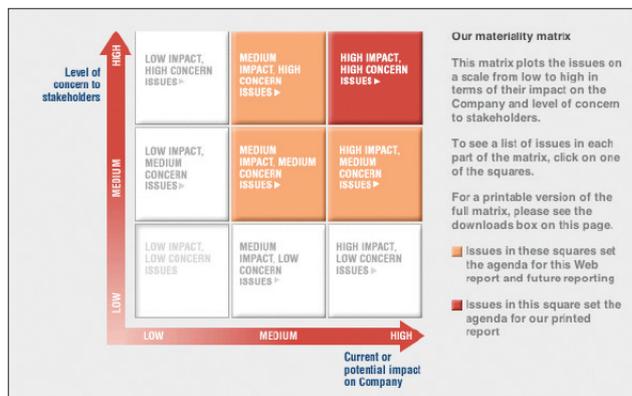


The zones were not always equal or square, and businesses often decided to draw several thresholds to delineate different levels of materiality and action. For example, both BT’ and Ford’s graphs below, reflect their decision to emphasise issues of highest strategic significance to the business in their sustainability report and cover a wider range of issues on their website.

### BT Group Plc’s Materiality Matrix



### Ford Motor Company’s materiality matrix.



Some businesses included a third axis. Nike, Ford and The Gap Inc. all analyse issues according to the company’s level of influence. Ford, for example, assesses the level of control or influence they have over an issue according to the extent to which the business’s operations and product offerings impact on the issue, but also the extent to which their freedom to act differently is constrained by factors such as technology limitations, costs and consumer demand. Nike also adapted the basic materiality

---

framework to consider issues and opportunities in the innovation and business growth arenas in addition to risk and reputation management.

### **Embedding sustainability thinking**

All the businesses studied approached the determination of materiality as an iterative process which involved cycles of internal review, checking and adjustment at every stage.

Most businesses said that they started by identifying issues through stakeholder engagement and then rating them internally in terms of significance. Telefonica did it the other way – identifying corporate risks and opportunities and then engaging with stakeholders to see how they rated them.

In addition to this ongoing iteration most organisations had built cycles of formal review into their materiality determination processes. Stakeholders, both internal and external, provided input in identifying issues, developing thresholds and significance criteria and debating and challenging preliminary conclusions.

*“Our materiality matrix helps us identify and frame each issue. We draw on multiple feeds including internal and external stakeholder engagement documentation, media coverage and industry and reporting benchmark studies. This yields in excess of 5,000 data points for clustering and analysis. Once we’ve identified the issues, we have a series of formal reviews about external expectations for our reporting.”*

David Bickerton, BP

*“The incorporation of stakeholder feedback is central to Nike’s approach to materiality. Nike’s Report Review Committee, who advises the company on what should be included in the CR Report, is a main mechanism for ensuring stakeholder viewpoints are considered when determining report content.”*

Charles Gatchell, Nike

Several businesses established committees or panels that provided a focus for reviewing the materiality determination process. These committees provide a useful concentration of views and proved an efficient and productive way of capturing a wide range of views and expertise. BT, for example has a Leadership Panel that provided independent guidance and expert advice. In particular its mandate was to advise on key areas of sustainable development strategy and performance, make sure that BT did not dodge difficult or uncomfortable issues.<sup>24</sup>

Most of the businesses studied included their materiality analysis within the scope of external assurance. They asked their assurance providers to give commentary and analysis on the materiality of subject matter, on the quality of materiality determination processes, and on the accuracy of data reported.

Some companies have begun to develop new modes of assurance such as stakeholder panels.<sup>25</sup> These are designed to consider questions of issue materiality with a lesser focus on technical quality of data or underlying management systems. As Mark Weintraub, Head of Sustainable Development, Shell, commented: *“Auditor verification of data at the early stages of reporting is a powerful tool to get your systems and data in order. But it has diminishing returns as your reporting matures. It can then become*

*a drain on resources and can divert your attention from tackling more critical issues. We were looking for a challenge from experts who understood the issues and knew how our business works. We wanted to have a conversation with these experts to help us manage the issues better. We feel our data systems and the numbers are sound and the auditors have helped us achieve this. Now we want to concentrate on improving performance.*"<sup>26</sup>

Although welcomed by many as an innovative and valuable exercise, not all stakeholders have been convinced by this type of approach. For instance, Nike used a stakeholder based Report Review Committee rather than professional assurance to comment on its report. Maplecroft's review of Nike's report states the following: *"While the Report Committee statement certainly provides valuable insights... it should not replace a more formal assurance process. Nike does not currently have a verification programme in place, and is currently speaking with stakeholders to determine whether to implement one. It is strongly recommended that Nike does so, as it is only through the rigor of an assurance process that the company will receive the useful critical feedback necessary to systematic target setting and continuous improvement."*<sup>27</sup>

## **LRQA's Approach to Assuring Materiality**

LRQA defines materiality as:

- ❖ The professional judgement of a verifier based on an understanding of the subject matter when:
- ❖ assessing completeness of information, its characteristics and suitability. (Informative materiality / material issues)
- ❖ establishing and evaluating acceptable threshold levels for data. (Technical materiality / accuracy of material information)
- ❖ evaluating evidence and determining the extent of evidence gathering to be applied, including the reasonableness of the reporting organisation's communication methods.

Effectively LRQA assesses materiality by comparing the results of its stakeholder research against those of our customer's. A lively debate then ensues over the differences (and also similarities), the decision to respond to these issues and whether feedback should be via the corporate report or other mechanisms. They challenge the logic and robustness of any corporate governance and management system controls used to determine materiality and confirm that these issues are being addressed by senior management as part of the Board's agenda and the day-to-day activities of the company.

---

### **Focused on reporting, but aiming at performance**

Most of the businesses that have so far developed and made public their approach to materiality are those that have been through several cycles of reporting, with ever widening scope, greater expense and heavier reports. The materiality processes have been driven by the need to consider what is really important to their business and to their stakeholders and to develop a basis for communicating and this internally and externally.

*“In recent years there has been a growing demand for more information about how we choose which issues to address in our reporting. In response, we evolved an internal materiality process that builds on our enterprise-wide risk management processes and matches this with a rigorous assessment of external concerns.”*

Adriana Mazry, BP

*“Our stakeholders were telling us on one hand that the report is far too long. But if we ask them what we are missing, they are also demanding more and more information to be included. So you need to use a funnel to filter all the issues.”*

Rafael Fernandez de la Conazon, Telefonica

Others are wrestling with materiality in order to move from a tight focus on a single issue to a wider assessment of the issues which are likely to impact on business success.

*“We are looking at how to evolve from a compliance and ethical sourcing focus where we have quite a robust program to broader social responsibility umbrella... In this evolution we are faced with a much broader array of issues and a much broader array of stakeholders so it makes prioritisation more challenging, it makes identifying our level of influence more challenging, even identifying stakeholder interests is more challenging”.*

Monica Oberkofler, The Gap Inc.

Businesses were also motivated by the desire to integrate social and environmental issues into core decision-making, governance and risk management processes;

*“We are trying to align boundaries and definitions of materiality between financial and sustainability reporting, but it is at an early stage. I would say there is currently more conversation than alignment... This is one of the priorities at the moment – to try to drive this in a more integrated and embedded fashion – everything we do is looking for ways that this is not an add-on process, it is integral to the way we do business.”*

Karin Ireton, Anglo American

*“We have developed an integrated report. Both sides – sustainability management and our financial department - have learnt from each other. Financial discipline has helped to strengthen the indicators and targets on the sustainability side. But you cannot try to measure sustainability issues in financial terms only.”*

Claus Frier, Novozymes

---

The businesses that undertook formal materiality determination processes generally emerged with issues categorised into three grades relating to reporting:

- ❖ **Strategically material issues:** information emphasised in the printed report.
- ❖ **Relevant but not material:** of interest to some stakeholders - information included in online report, regional reports or other communication, and considered for greater focus in the future.
- ❖ **Not material to business or stakeholders:** not reported on.

The businesses then used these categorisations to determine the scope of the issues covered by their sustainability report and to explain these choices as part of their reporting.

*"I'm convinced that this approach to reporting will mark the end of the massive printed tome which tried so desperately to give a voice to every stakeholder no matter how tenuous their relationship with the business. No more paper given over to every indicator ever postulated. Rather, tightly focussed reports highlighting key performance indicators and clearly indicating how CSR is interlinked with the company's commercial success."*

Chris Tuppen, BT

However, as well as informing report contents, practitioners also reported that the materiality process advanced corporate thinking and critical relationships and fed into decision making in a number of other ways by advancing debate internally, feeding

into strategy development and mainstream risk assessment processes.

*"Because the tool is built upon an established enterprise risk management process it is well-respected internally and helps to structure an informed debate with BP senior management. It is rigorous and it is really about the response to business risk and opportunity - so it is taken seriously."*

David Bickerton, BP

Many of the questions on materiality, beyond the initial one of whether an issue should be the subject of reporting or not, are not in fact captured within the formalised part of the determination process although they are certainly the focus of discussion. Relating the analysis of issue significance to decisions about what information to actually report, to whom and how still remains more of an art than a science.

*"We wanted this to be a more objective way to define issues for the report but it wasn't a completely scientific approach. It was difficult to balance the desire to be objective with the feeling that this was also a subjective process. During the first round, this was compounded by the fact that we didn't have data for all stakeholders. The other challenge in terms of prioritisation is that sustainability issues tend to be interrelated so there was a frustration in trying to separate out these issues so distinctly."*

Krista Gullo, Ford

---

*“We do not set thresholds in terms of percentage of impact. Five percent works in the financial world, but it does not work in the non-financial world. However, we have evolved an internally transparent process of rigorous calibration that stands up to the scrutiny of our internal management processes and external assurance.”*

David Bickerton, BP

One clear challenge was in deciding where to draw the line in relation to joint ventures and contractual relationships where the company itself was not in a position of overall responsibility.

Nike for example currently only covers its own brand within its report, not subsidiary sportswear brands, although it plans to expand corporate responsibility reporting and activities to cover all subsidiaries in the future. BP has established three levels of sustainability reporting: its group report, country reports and selected local site reports. They aim to report on all aspects of the business, including joint ventures where they do not have direct control but do have influence.

### **Standardised, but not mechanised**

Whatever their formal approach, interviewees stressed that it wasn't applied mechanically and that the debate was a very helpful part of the process which stimulated learning and thinking about how issues aligned with corporate strategy.

All the businesses emphasised that the methodologies used are only as good as the people applying them and that they need to be flexible enough to enable, not stifle debate within the business as well as between the business and its stakeholders.

*“You need to be careful not to be too constrained by a rigorous protocol that you've created and have flexibility somewhere in there to accommodate alterations. But it shouldn't be the company alone that makes those alterations. It should do it in consultation with an external voice. Be careful not to create a strait jacket – you may end up ignoring some oddities that pop out at the end and miss an important point.”*

Chris Tuppen, BT

*“If one has people with sufficient depth of understanding and sufficient seniority within the company, then you have a vehicle for addressing these issues. If you are pushing this to a level down the organisation where it is a junior staff member taking an off the shelf process and applying it, what you will get is the fairly obvious issues, but not necessarily the level of thinking and innovation and change management which to me is an essential part of this agenda. ...the report should not be disjointed from a programme, but a stage of a programme”*

Karin Ireton, Anglo American

Where businesses have developed formalised approaches they report clear benefits in terms of credibility within the business and with external assurers.

*“We are a very systematic company driven by an engineering mindset. There is a lot of pressure on us that if we put something on this matrix we have to have the evidence to qualify it. The people who oversee the reporting have agreed with the materiality process and its rigor. So if something lands in there we have to consider it... As we have involved more people in the materiality experience, they have become more engaged on the issues. They like that it is a scientific approach. It has made us more credible internally and with our auditors.”*

Adriana Mazry, BP

---

It is likely that formalised frameworks will become more widely used, as they provide a framework for making, and demonstrating that you have made, difficult decisions based on good evidence and transparent assumptions.

The reporting teams involved had a set of common competencies which were necessary to make the materiality determination processes effective:

- ❖ **Understanding of corporate strategies and credibility with internal teams** developed through ongoing involvement in strategic planning, corporate reporting and working with individual operational teams.
- ❖ **Understanding of the issues**, ongoing debates and operational implications. However the implementers did not have expert knowledge on all the issues but drew on experts from within and outside the business where necessary.
- ❖ **Ability to develop and tailor a methodology and supporting systems** to ensure that they were workable and useful within the business and to understand what stakeholder inputs were needed to ensure they were credible externally.
- ❖ **Ability to build relationships and credibility with external stakeholders** developed through ongoing involvement with external organisations, involvement in partnerships, multi-stakeholder initiatives and expertise in the design and facilitation of more formal engagement approaches.

The materiality framework helped to translate ongoing and complex internal and external engagement processes into clear-cut and clearly communicable sets of conclusions. The process itself also contributed to significant learning amongst those involved. Companies reported that sustainability managers were able to better understand corporate priorities and financial and operational managers were better able to understand the issues of sustainability.

---

*“What we’ve had in the past is a group of financial professionals working on financial risk in isolation and other people working on other risks in isolation – what we’re trying to do is find a much more integrated mechanism where Sustainable Development could not be separated out of the process.”*

Karen Ireton, Anglo American

### **The integration challenge**

All the businesses studied saw understanding the materiality of social and environmental issues as a board level responsibility. Each business had its own approach to linking the materiality process into governance. They generally involved sign-off at Board and senior management levels at some stage, either overseeing the materiality determination process itself or the subsequent sustainable development strategy or public report.

Some companies are beginning to build on their initial experimentation with their materiality determination processes to ask how it can be more closely linked with core decision making and performance management processes.

*“One of the interesting questions that we can begin to look at now that we’ve got this process is how it links in with management and decision making. We’ve also got our KPIs, our CSR risk register, and there isn’t exact alignment between the most material things and the things that appear on our risk register or the things that are in our KPIs. Now we have developed this new process we need to go back and take another look at the processes we’ve had in place for some time.”*

Susan Morgan, BT

### **How good is leading practice?**

These first generations of materiality determination approaches meet an important need to focus the content of sustainability reports on strategic issues. They have enabled issue experts to better understand and speak the language of business, and have engaged senior managers in understanding emerging sustainable development issues that could affect the business performance.

There will never be a definitive answer to the question of materiality with which everyone is completely satisfied. By its nature it will always be an iterative process of responding to changing circumstances. The emerging common methodology, however, has made the process, assumptions and evidence base for identifying material issues more transparent and therefore amenable to both assurance and debate.

Businesses are still mainly concentrating on using materiality to think about how they reflect business strategy in their reporting, rather than how they can use it in directing strategy and performance. Although the businesses have indicated that the process did feed back into strategic decisions, it is primarily used as an end-of-pipe filter to help produce more streamlined and useful annual sustainability reports.

The development of clear methodologies and criteria has enabled businesses to capture expertise within the process itself, so that it can be widely and consistently applied year on year, and within different sub-units of the global business. But, with the focus on developing standardised methodologies, there is a danger of overlooking the underlying competencies necessary to make the process effective in driving

## Summary assessment of leading edge sustainable materiality practice

Achievements	Challenges
Tackles need for more strategically aligned and useful performance reports.	Integration with mainstream measures of materiality.
Brings together stakeholder expectations and business priorities in a single framework.	Transparency of criteria and thresholds
Makes the process, assumptions and evidence base for identifying material issues more transparent and amenable to both assurance and debate.	Linking material issues with information requirements.
Clear format for communicating basis of materiality	Avoiding a mechanistic approaches – contributing to learning
	Addressing material issues at organisational boundaries

learning and decision making. As with reporting, the materiality process itself may become subject to data automation or delegation to junior staff.

Professional judgement and skills, albeit informed by clearer criteria and quality data remain critical in the determination of materiality. Stakeholder engagement skills tied to a clear understanding of business strategy are the key competencies for working out how sustainability issues matter to the business.

The table below summarises the achievements of the first generation of approaches and the challenges it faces in going beyond reporting to driving sustainable development issues into the heart of strategy development and operational management. These challenges are discussed in more detail in Chapter 5.

## 4. The Materiality Framework

---

This chapter sets out The Materiality Framework: a basic methodology for identifying and assessing issues material to a business's sustainable performance.

The Materiality Framework is designed to be used to help leaders, managers and communicators within business to:

- ❖ **Better understand the alignment** between sustainable development issues and business strategy.
- ❖ **Develop corporate reports** and broader communication and engagement strategies that are more strategically aligned and useful to external stakeholders.
- ❖ **Influence internal debates and strategy development** by highlighting the matches and mismatches between current business strategy and emerging opportunities and constraints.

The Materiality Framework has been designed for businesses seeking to apply a rigorous, yet practical approach to materiality determination. It can be used within the framework of relevant reporting requirements and assurance standards, in particular the AA1000 Assurance Standard, GRI G3 Guidelines and ISAE 3000.

It is intended as a basic foundation which businesses can tailor to meet their needs and those of their stakeholders. The Materiality Framework therefore comes in several interlocking parts:

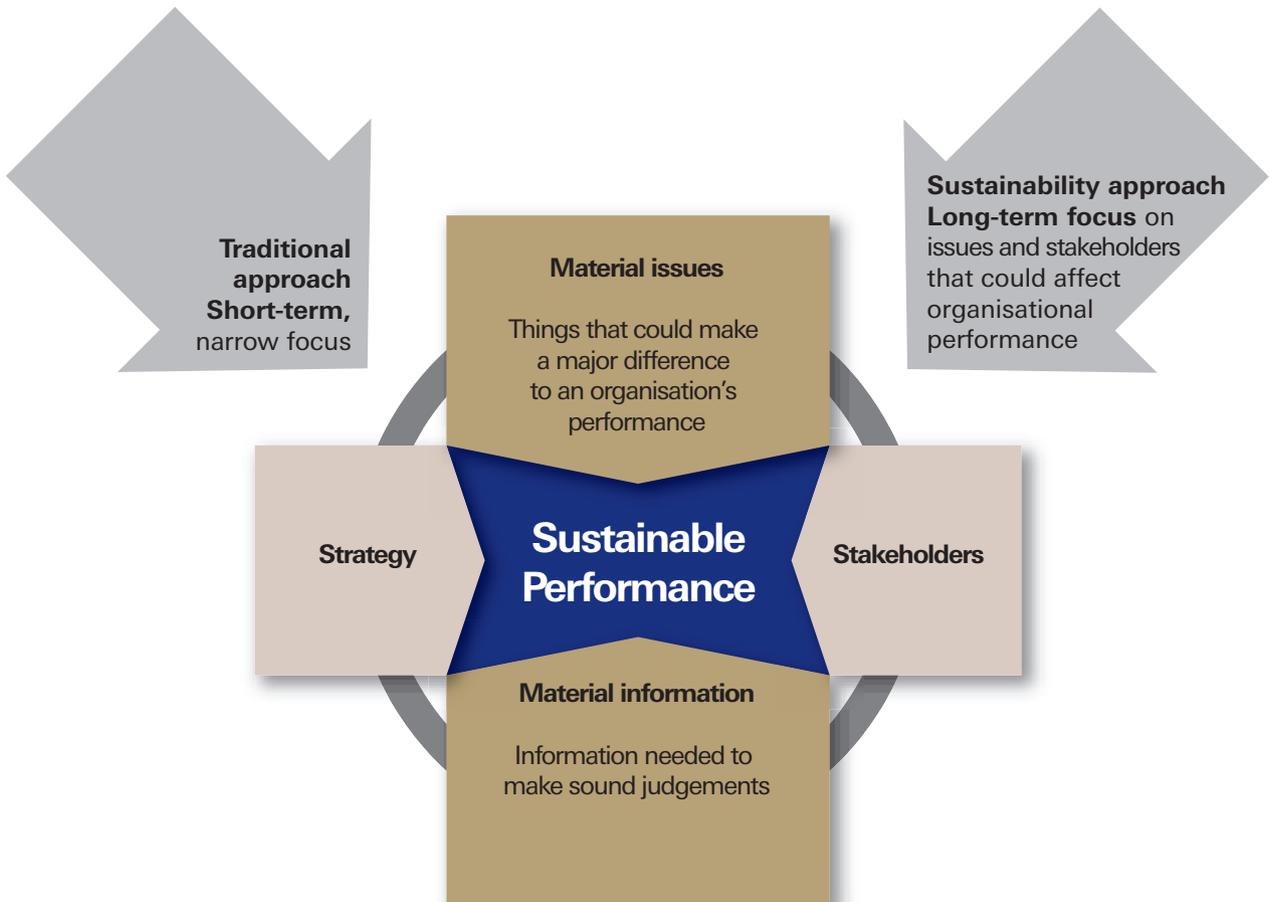
- ❖ A clear working **definition of materiality**
- ❖ A high level set of **design principles** which can be used to guide the development of any materiality methodology
- ❖ A **series of questions** to guide businesses through the design, planning and preparation steps necessary to tailor the methodology to their own needs.
- ❖ A **practical outline of the core process** being used by leading companies to determine materiality.

**Part A: Working definition of materiality**

*Material issues are those things that could make a major difference to an organisation's performance*

*Material information provides the basis for stakeholders and management to make sound judgements about the things that matter to them, and take actions that influence the organisation's performance.*

In terms of sustainability reporting, and more broadly managing sustainable businesses, the question of 'what is material' is framed to include the information needs of *both* management and investors *and* other stakeholders who take decisions which can affect a business's performance in the long-term.



---

## Part B: Design principles for materiality determination processes

Approaches will differ and develop but any successful methodology to determine materiality will need to address a set of common issues and challenges:

<b>It needs to be able to:</b>
<b>Identify and prioritise issues for action</b> according to degree of significance to the business.
<b>Determine what information is useful and meaningful</b> to different stakeholders.
<b>It should be based on:</b>
<b>Broad-based and inclusive</b> research and engagement with stakeholders.
<b>Strong alignment</b> with business strategy and value drivers.
<b>Clear and transparent</b> criteria to help decide what is material.
<b>Integration and embeddedness</b> into governance processes.
<b>It needs to be:</b>
<b>Rigorous</b> Replicable, defensible, assurable and credible.
<b>Practical</b> Simple enough to be widely used and communicated, sophisticated enough for the needs of complex organisations.
<b>Purposeful</b> Able to trigger action, not just defend it.

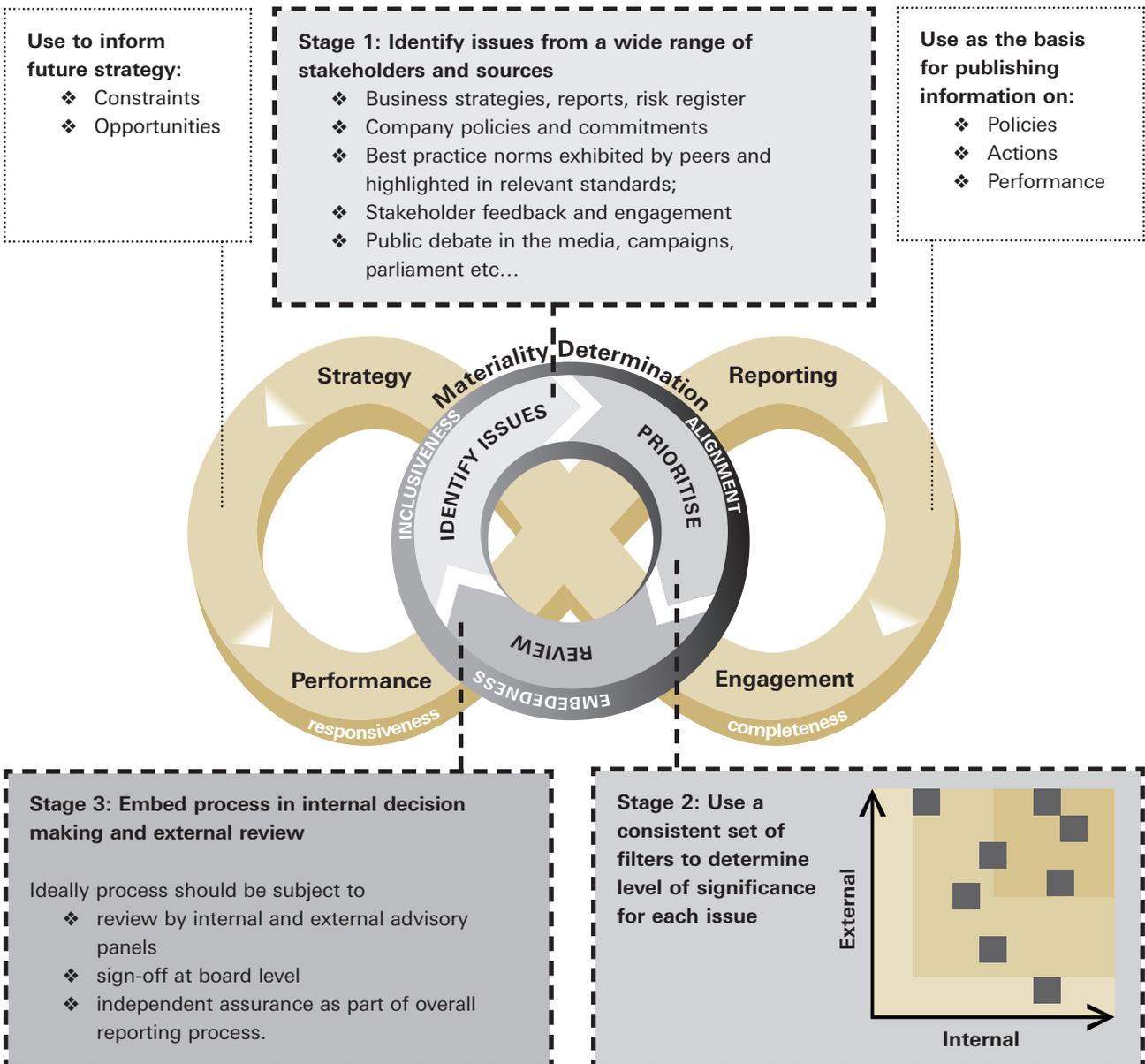
## Part C: Implementation questions

Before embarking on the core approach outlined, a business would need to go through a number of design, planning and preparation steps to tailor the methodology to their own needs and ensure they are able to implement it effectively.

Planning stage	Key Questions
<p>Consider <b>current processes of materiality determination</b></p>	<ul style="list-style-type: none"> <li>• What social and environmental issues are currently considered material enough to report on and manage?</li> <li>• Are a set of core sustainability issues and value drivers identified? How are these decided on and reviewed?</li> <li>• Who are the stakeholders who affect and are affected by your organisation's activities?</li> </ul>
<p>Understand existing <b>stakeholder engagement</b></p>	<ul style="list-style-type: none"> <li>• How do you engage with them and how is stakeholder based learning and information is used to inform decision making</li> <li>• Is a single corporate level materiality process sufficient or do you need to cascade this to multiple reporting streams?</li> </ul>
<p>Decide on the <b>scope and objective</b> of the materiality process</p>	<ul style="list-style-type: none"> <li>• Are you seeking to assess materiality of issues and information for reporting and/or for action?</li> <li>• Is there commitment to the process and to reviewing and signing off its conclusions at board level?</li> </ul>
<p>Embed materiality decisions into <b>governance</b> process</p>	<ul style="list-style-type: none"> <li>• Will the process and its conclusions be subject to external review and assurance?</li> <li>• What information streams do you need to draw on to capture the views and actions of all key stakeholder groups?</li> </ul>
<p><b>Tailor the materiality methodology</b> to reflect own context</p>	<ul style="list-style-type: none"> <li>• What are you seeking to capture in your internal and external rating of issues?</li> <li>• What thresholds do you need to set in order to generate useful results (e.g. reporting thresholds, action thresholds)</li> <li>• Do implementers have sufficient skills and knowledge of stakeholders, corporate strategy and specific issues?</li> </ul>
<p>Determine <b>who needs to be involved</b> in the process</p>	<ul style="list-style-type: none"> <li>• Are the people involved at sufficient levels of seniority to take decisions and challenge received wisdom?</li> <li>• Have you recorded a clear description of the methodology (including key assumptions)?</li> </ul>
<p>Make sure the <b>methodology is assurable</b></p>	<ul style="list-style-type: none"> <li>• Have you set up a system to keep up-to-date records of its application and evidence of how the results were used?</li> <li>• Are both materiality of issues and information included within the scope of your assurance specification?</li> </ul>

## Part D: The core process

The core process is based on a cycle of three broad stages: identify issues, prioritise and review, embedded within an ongoing process of strategy development and performance management, and reporting and stakeholder engagement.



---

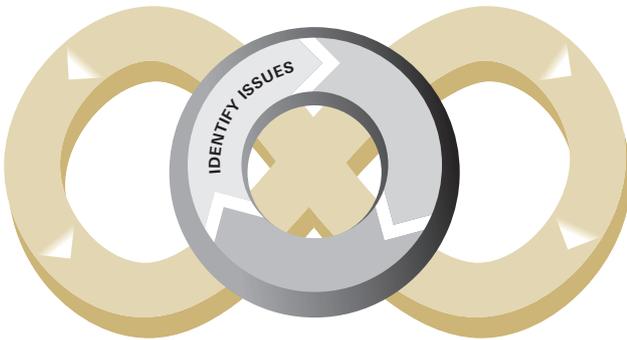
Of course the process is neither as simple, nor as neat as the bare bones outlined here. In practice the three key steps presented as a cycle often overlap with each other or double back in iterative loops. For example, in identifying issues, information can also be collected that will help in assessing issue significance, in reviewing the findings companies often seek further information about an issue which causes them to go back and revise their assessment of its importance. Stages in the methodology also link with other ongoing processes within the business; for example they feed into and out of other processes of stakeholder engagement, market research, risk management and strategy development.

In each of the following stages  indicates a necessary step and  indicates an optional consideration.

### Stage 1: Issue identification

*Aim: to identify the widest possible selection of environmental, social and economic issues that are, or might turn out to be, relevant to the business and to its stakeholders, and to collect the information needed to assess their significance.*

*This stage should be guided by **inclusivity**, in particular acknowledging stakeholders' right to be heard.*



- ✓ **Identify a long list of issues** relevant to direct short-term financial performance, ability to deliver on strategy and policies, best practice norms exhibited by peers, stakeholder behaviour and concerns and societal norms.

Include issues which are relevant to existing strategies, policies and performance management and those which might pose new risks and opportunities.

Enable all significant stakeholders' viewpoints to feed into the analysis – either through direct engagement or through the use of relevant advocates, standards and research.

Draw on internal and external sources of information. This can include monitoring of issues raised by stakeholders, accumulation of evidence from different parts of the business, active stakeholder engagement focused on sustainability issues and use of existing research, standards and regulatory benchmarks. The table on the following page maps out the key information streams and sources.

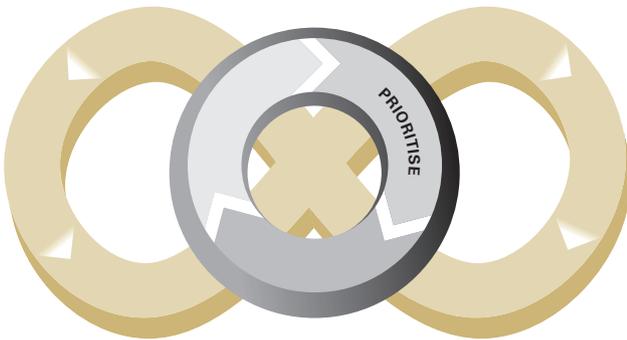
- ✓ **Document the process** and record information to facilitate analysis and assurance.
- ≡ Breakdown issues into different action and reporting streams, for example according to whether they are relevant at international, national or individual plant level, or to reporting themes such as environment, social and economic issues.

<p><b>Information about</b></p> <p>short-term risks and opportunities; issues that may impact ability to deliver on its strategic objectives</p> <p>Stakeholder behaviour and concerns</p> <p>Best practice norms</p> <p>Societal norms, future regulation.</p>	<p><b>Information streams</b></p> <p>Internal business priorities</p>	<p><b>Key sources</b></p> <p>Business objectives, strategy and policies</p> <p>Sustainable development strategy, KPIs and previous reports</p> <p>Internal risk analysis and corporate risk register</p> <p>Financial reports and regulatory disclosures (10K, etc.)</p>	Internal sources
	<p>Stakeholder relationships with different parts of the business</p>	<p>Letters from regulators and NGOs</p> <p>Customer feedback, surveys and complaints</p> <p>Shareholder resolutions, SRI questionnaires and investor queries</p> <p>Feedback received on previous reports</p>	
	<p>Active engagement with stakeholders</p>	<p>Surveys with individual stakeholders (customers, employees, suppliers)</p> <p>Generalised stakeholder dialogue, roundtables etc...</p> <p>Focused stakeholder dialogues (e.g. on a particular issue or company programme)</p> <p>Ongoing one-to-one relationships with external organisations</p> <p>Report review committees or stakeholder panels, and</p> <p>Dialogue within industry and multi-stakeholder groups and initiatives.</p>	External sources
	<p>Emerging stakeholder consensus as reflected in relevant standards</p>	<p>Voluntary standards e.g.: UN Global Compact principles and GRI indicators</p> <p>Environmental, EHS and occupational health management systems</p> <p>Multi-sector standards and agreements</p> <p>Peer based norms, sector standards and benchmarks</p> <p>Intergovernmental agreements e.g.: ILO standards, Millennium Development Goals.</p>	
	<p>Issues and debates</p>	<p>Media reports</p> <p>Parliamentary questions, bills and government white papers</p> <p>Public opinion surveys</p> <p>Published research</p> <p>Civil society campaigns</p>	

## Stage 2: Prioritisation

*Aim: to sift out the issues according to how significant they are and therefore to identify the information flows needed to enable sound decision making and action.*

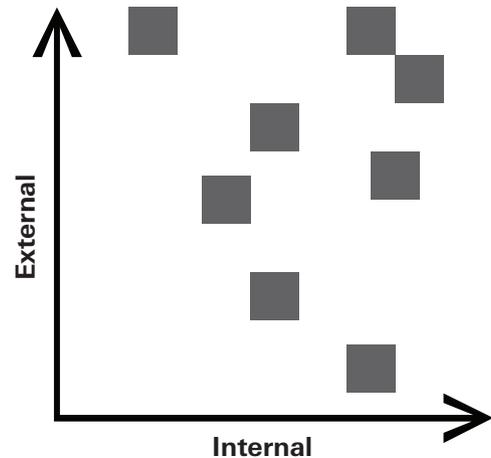
*This stage should be guided by **alignment**, to ensure that the issues most significant in the specific business context are highlighted.*



- ✓ **Choose internal and external criteria** to identify those issues relevant to drivers of business strategy and performances and those issues which are most important to the stakeholders.

Key factors to look at in assessing internal significance include: direct financial implications, reputational risks and opportunities, potential effect on operational performance and strategic opportunities to boost competitive position.

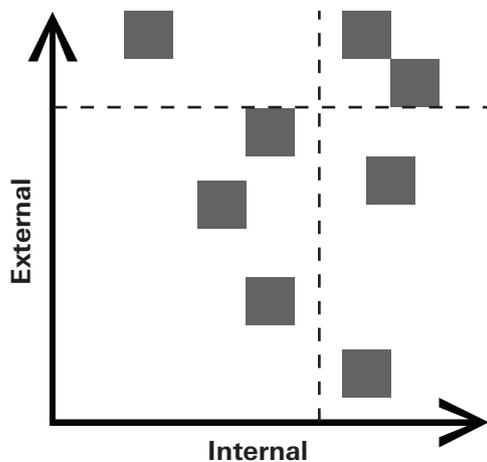
Key factors in assessing the level of stakeholder interest in an issue might include the extent of media coverage, a tally of the



number of complaints, survey results or a count of the number of unprompted mentions by stakeholders. The external criteria should be weighted to reflect most strongly those stakeholders that can influence the business.

The choice of specific criteria and the differential weighting given to aspects of business significance are crucial in determining the final outcome. A focus on risks and liability would push the analysis towards a middle of the pack or do-no-harm approach to sustainable development issues, whilst a focus on strategic opportunities would help to create a framework for identifying which social and environmental factors could be drivers of innovation.

- ✓ **Decide on thresholds on the internal and external axis to divide the map into bands of materiality.** Essentially, these are the thresholds which indicate whether an issue is significant enough to the business to provoke corporate action (and at what level) on one

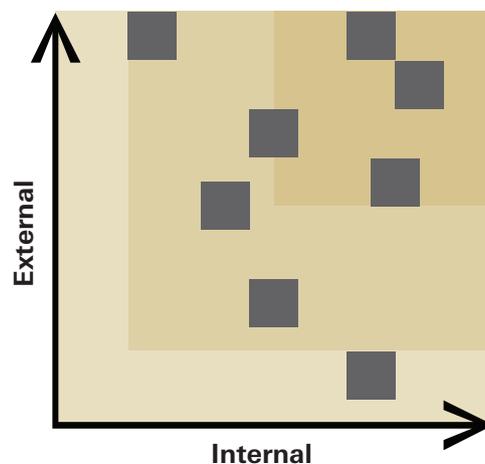


hand and whether it is significant enough to provoke stakeholder action (and at what level) on the other.

This may be a simple division into material/not material categories or it could be more sophisticated, indicating a scale of levels of materiality for example – thresholds on the internal axis might sort issues into strategic performance, operational performance, compliance and not material categories.

Implicit in any threshold is a time horizon. The company should be clear and transparent about the time horizon under consideration.

Criteria and scales should be clear enough to be meaningful in communication and decision making and rigorous enough to ensure that ratings are defensible and replicable. Levels of granularity should be realistic.



- ☑ **Use the criteria, thresholds and evidence to prioritise each individual issue.** Issues are plotted on the matrix within zone, representing their level of significance to the organisation and to its most significant stakeholders. Each zone should correspond to a commitment to address issues in an appropriate way.

Most companies have started by classifying the issues into three or more zones relating to the decision to focus on, include or omit an issue from reporting.

	<b>Interpretation</b>	<b>Reporting</b>
<b>Material issues</b>	<p>Issues critical to the success of the business strategy and to its stakeholders.</p> <p>Issues should be central to management systems and key performance indicators.</p>	<p>Issues emphasised in reporting, making clear how they link to business strategy.</p> <p>Performance indicators are likely to be clearly defined, however there may be subsidiary issues where materiality and information needs are more contested.</p>
<b>Relevant but not strategically material</b>	<p>Relevant as:</p> <ul style="list-style-type: none"> <li>• compliance requirements</li> <li>• operational performance issues</li> <li>• stakeholder perception issues but not central to business strategy.</li> </ul> <p>Some issues may inform future strategy development, particularly where stakeholder concern is rising.</p>	<p>Often associated in practice with the interpretation 'report on the website', but this is only the most basic analysis.</p> <p>Reporting on these issues might mean reporting to specific interested stakeholder groups or contributing to emerging debate.</p>
<b>Not material</b>	<p>Low priority.</p> <p>Issues do not warrant significant action or reporting on at this stage. However, should continue to be monitored.</p>	<p>No detailed reporting on issues in this zone, although the issues themselves should be disclosed.</p>

- ☑ **Assess each issue according to the agreed criteria** and assign them to different bands of materiality

This may be done through a qualitative analysis and discussion or a scoring system. Either way decisions should be guided by what it is you wish to assess (for example risks or opportunities) not just which criteria are easiest to assess or trans-

late into a numerical value. A recent IAASB Discussion Paper specifically warns against confusing materiality with measurability: if something cannot be easily measured, it doesn't mean that it is not material.<sup>28</sup>

The thresholds, criteria and underlying assumptions should be clearly documented and become part of the assurance and reporting process.

---

≤ **The basic methodology and matrix can be adapted** for different needs and applications either in reporting or strategy development. More than one simple matrix may be needed, and further matrices, layers, zones or axes can be used to break the analysis down to:

**identify emerging risks and opportunities** – Issues at the far end of only one axis highlight a mismatch between the level of corporate action and stakeholder concern. This may highlight an untapped opportunity or a wasted effort on the firm’s part, or it may be an early warning sign of growing reputational or operational risk or pressure for legislation.

**link into performance management and different areas of internal significance**, for example to show issues material to operational excellence, building brand reputation, attracting investment and being prepared for new regulations.

**relate to different reporting streams**, for example in relation to reporting themes, global, national or local relevance or particular stakeholder communication streams.

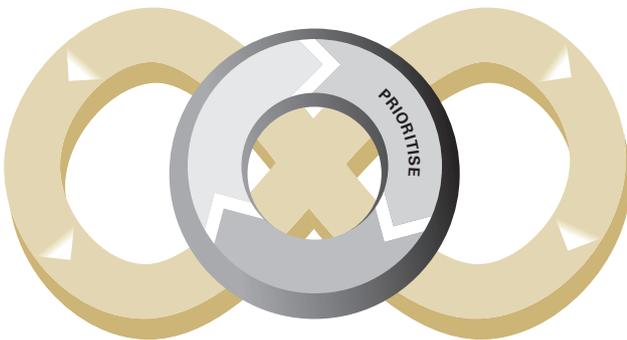
**analyse the implications of taking longer time horizons on board**, for example showing which issues would become material if the business took a longer view of its performance.

**assess the businesses ability to influence**, a third dimension (indicated by size/colour of issue points) can be added to evaluate ability to influence – highlighting where the business can act alone, and where it may need to work with others.

### Stage 3: Review

*Aim: To ensure that the materiality determination is considered sound and credible both internally and externally and that the business has accepted its findings and considered their implications.*

*This stage should be guided by **embeddedness**, to ensure that the thinking on materiality is integral to internal decision making.*



- ☑ Internal and external review processes not only strengthen and validate the materiality analysis, but can play a critical part in internal learning and external dialogue on emerging issues. In-built review processes should include:

**Checking.** Throughout the materiality determination process the implementation team should review the information sources, data and analysis, seeking further information as necessary, either from stakeholder sources or internal points of expertise and accountability in order to resolve queries, establish clear evidence for their conclusions and highlight significant differences of opinion.

**Review by internal and external expert advisory panels.** With opportunities to feedback, challenge and iterate on the method, criteria and thresholds, interpretation of evidence, consideration of materiality, reporting requirements and actions on individual issues.

**Agreement at Board level.** The materiality determination criteria and outcomes should be agreed at Board level.

- ☒ **Ideally, materiality assessment should be included within the scope of independent assurance of reporting.** Assurance providers may attest not only to the accuracy of reported information, but to the scope of the issues and to challenge and to the processes of issues identification and identification. Both the GRI G3 Guidelines and the AA1000 Assurance Standard provides compatible guidance on the principle of Materiality.

## **G3 Materiality Tests**

### ***External Factors***

In defining material topics, take into account external factors, including:

- Main sustainability interests/topics and Indicators raised by stakeholders.
- The main topics and future challenges for the sector reported by peers and competitors.
- Relevant laws, regulations, international agreements, or voluntary agreements with strategic significance to the organization and its stakeholders.
- Reasonably estimable sustainability impacts, risks, or opportunities (e.g., global warming, HIV-AIDS, poverty) identified through sound investigation by people with recognized expertise, or by expert bodies with recognized credentials in the field.

### ***Internal Factors***

In defining material topics, take into account internal factors, including:

- Key organizational values, policies, strategies, operational management systems, goals, and targets.
- The interests/expectations of stakeholders specifically invested in the success of the organization (e.g., employees, shareholders, and suppliers).
- Significant risks to the organization.
- Critical factors for enabling organizational success.
- The core competencies of the organization and the manner in which they can or could contribute to sustainable development.

### ***Prioritising***

- The report prioritises material topics and Indicators.

### **AA1000 Materiality Guidance Note**

The following criteria provide a benchmark for evaluating adherence to the Principle of materiality. An Assurance Provider will need to establish what is required to determine that these criteria are met and what evidence is necessary.

Different levels of assurance may require different levels of evidence.

1. Is there a process in place to determine what is material?
2. Does the process include an evaluation of relevance?
3. Does the process include an evaluation of importance?
4. Does the process fairly represent the views and importance of stakeholders?
5. Are the criteria for evaluation clear and understandable?

6. Is there a process for resolving conflicts or dilemmas between different expectations regarding materiality?
7. Have the processes been systematically applied?
8. Is the determination of materiality consistent with stakeholder views?
9. In your professional judgement, are there any material omissions or misrepresentations?

### ***Closing the loop with strategy, performance and reporting***

The endpoint of the materiality determination processes is a map of the issues that could drive business strategy and performance now and in the future. It illuminates not only what a business should report on but where strategy needs to be responsive to changing social and environmental circumstances. It can be used in a number of ways:

- **To determine the scope of corporate reports** and other communications so that they are more strategically aligned and useful to external stakeholders. This has often been the initial primary purpose for such materiality assessments. The matrix itself and details of the process and findings should be included in the report. Ford for example uses it as one index for their online sustainability report, enabling users to click through from the matrix to what the business is doing in relation to individual issues.
- **To promote internal understanding of the link between sustainable development issues and business strategy.** The materiality determination provides a link between issue experts and strategic and operational managers.

- **To feed into ongoing strategy development** by highlighting rapidly emerging issues and enabling them to be factored into strategy development and possibly addressed as business opportunities, rather than ignored until they become business risks.

- ☑ The materiality assessment should be reviewed regularly allowing both its criteria and assumptions to be revised if necessary and enabling its analysis to keep up with the shifting state of the issues and corporate strategy.
- ☑ Internal review of the results of the formal analysis should consider its implications for reporting, risk analysis and strategy development.
- The matrix can be used as a basis to begin more detailed discussions of data requirements, for example how much to aggregate information across different parts of business operations, how much detail to report on, and what indicators to use.
- Issues identified as material for the purpose of sustainability reporting should be considered for inclusion within mainstream corporate risk registers and reporting.

- 
- ▮ The materiality assessment has been designed as an annual cycle, tied into sustainability reporting. While this may not be the only, or even an enduring way in which businesses address questions of materiality it is a good place to start.

## 5. Materiality Futures

This chapter outlines the key challenges that need to be addressed by ongoing iterations in the way that businesses and their assurance providers determine and communicate materiality.

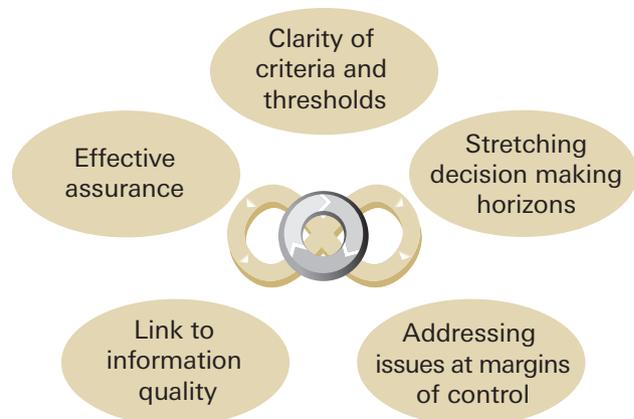
Clear criteria and evidence-based processes have enabled businesses to gain credibility for their approach to sustainable development issues internally and externally. However there is still a gap between sustainability focused reporting and mainstream business planning and performance management.

This first generation of sustainability focused materiality approaches share a number of common features which are not inherent to an effective approach to materiality. They have tended to be part of annual cycles tied into sustainability reporting, 'owned' and operated by corporate responsibility departments. Future developments, which seek to direct business strategy, may not be limited to these applications but can build on the first generation approach's basic principles and strengths.

The challenge of integration is not just for sustainability focused materiality to come closer to the rigour of financial measures, but also for mainstream reporting to addressing the question of materiality which looks beyond the short-term. Governments, regulators and international accounting bodies are increasingly focusing on the question of how mainstream corporate reports can better reflect their forward-looking strategies, risks and opportunities. In particular they recognise the need for more guidance and regulations relating to narrative reporting accompanying financial statements. Significant recent developments include:

- ❖ The EU Directive for modernisation of accounting which requires that non-financial information be included and audited within the annual report.
- ❖ The German Reform Act on Accounting Regulations which requires annual reports to include a narrative analysis including both financial and non-financial Key Performance Indicators(KPIs).
- ❖ The International Accounting Standards Board (IASB) Discussion Paper on Management Commentary which included an in-depth review of current national guidance and requirements that sought comments with a view to developing international guidance with a view to enhance, amongst other things, the inclusion of forward-looking information in financial reporting.<sup>29</sup>

There are a cluster of key challenges that future iterations in materiality determination will have to tackle, whether in sustainability reporting, mainstream accounting and reporting or internal strategy development and performance management.



---

## **Clarity and transparency of criteria and thresholds**

Deciding where to draw the thresholds dividing material from non-material is one of the key judgement calls in understanding and responding to emerging issues. There is still little in the way of broad consensus about what might be a valid threshold.

Businesses are still unclear about the basis for the thresholds they use, making it impossible to compare the calibration of different business's materiality approach and prompting some to describe them as arbitrary lines or as implicitly lower standards of materiality than financial measures.<sup>30</sup>

The thresholds of materiality may be difficult to assess, but they should not be seen as arbitrary. They indicate the thresholds where issues become significant enough to provoke stakeholder action and therefore corporate action. Providing more clarity as to the time horizons which are the implicit basis of the material thresholds would give more credibility to the methodology. It would bring a critical part of the materiality process and its underlying assumptions out of the 'black box' and into the arena of debate where they can be subject to internal and external review and compared against peers. For example, a business that claims to be managing for long-term sustainability would not have much credibility if it only considers issues which impact on the business in the next year to be material.

## **Stretching the horizons of decision making**

The businesses within this study that checked the material corporate responsibility issues against corporate risk thresholds found that nothing new had crossed the barrier into the realm of financial materi-

ality. When compared in this way it seems as if these new materiality measures are simply picking up issues which are less material than the traditional measures, and that therefore the detractors are right in saying that sustainable development considerations are a distraction from the business of business.

However, the implicit spectrum which separates the 'financial' and 'sustainability' thresholds of materiality should not be ones of decreasing importance, but of increasing time. Sustainability materiality processes aim to pick up not on issues that would impact on less than 5% of earnings in the next year, but on issues that could impact on 5%, 10%, 50% or more, or indeed on business survival, within the next 5, 10 or 20 years.

This distinction based on time horizons points the way towards an understanding of how different assessments of materiality can be integrated. Making the time horizons which underlie materiality thresholds in financial and sustainability reporting explicit would provide a clearer basis to investors and other stakeholders to comparing the ability of different businesses to manage for long-term sustainability. It would also provide a clearer basis for integrating these issues into strategy processes, such as backcasting, scenarios and contingency road maps.

## **Materiality at the margins of corporate control**

One of the key challenges raised by practitioners was the need for a Materiality Framework able to address different levels of control and influence. In part this may be addressed by future methodological refinements, but it also calls into question governance and accountability in joint ventures. Governance, finan-

---

cial-management systems and social and environmental responsibility in joint ventures are often out of line with the standards upheld by parent companies. Whether they are shielded from performance scrutiny is simply because they are on the corporate periphery, or more worryingly because other partners would not accept higher standards of accountability, weak governance leads many ventures to fail or fall short of expectations. They risk both the parent company's direct investment and expose it to wider and reputational risks.<sup>31</sup>

Both the GRI and the AA1000AS provide some guidance on the Reporting boundary in the context of level of control and influence. They make clear the principle that issues that are material to corporate performance are not confined to areas of organisational control but also include areas of influence. Thus any enquiry into 'what is material' should extend beyond the organisation's usual expression of its boundaries to areas such as the impacts of product use, the supply chain, subcontractors, and sector performance.

Of course, this is not a question which can be addressed purely through methodological guidance. In particular it calls into question whether standards of corporate governance and transparency are extended to joint ventures.

The practice of materiality determination and reporting has to avoid tying joint ventures into several sets of incompatible materiality criteria, environmental and social commitments and reporting processes. Solutions to this would need to be negotiated between all partners, but would be likely to mean including higher governance, transparency and social and environmental performance standards in the joint venture agreement from the outset.

### **Linking material issues with information requirements.**

The Materiality Framework also has further to go in terms of providing more granular assessments of user information needs (both internally and externally) which might go beyond the three basic conclusions of emphasise, include, or omit a particular issue from reporting.

At present the Materiality Framework helps businesses decide what they need to report on but not whether this should mean reporting on commitments, actions, key performance indicators or compliance with standards, to whom and in what detail. This is an increasingly important question for businesses seeking to communicate about the way they are addressing long-term challenges to a wide range of audiences internationally. A closer consideration of different stakeholders' actual interests and information needs would integrate questions about what information is necessary with the analysis of what issues considered likely to impact on strategic performance. As we have seen *what is important* does not necessarily correspond with *what can be easily quantified*.

Further developments in the methodology would help organisations to identify more rigorously for their targeted audiences, what information, at what time, in what format, with what level of accuracy, detail, aggregation and forward or backward looking focus, are needed. This would enable them to link assessment of issue materiality with the development and assurance of the systems that ensure:

- ❖ internal decision makers have the information they need to meet (and sometimes trade-off)

---

financial, legal, environmental and social goals in the course of their work

- ❖ stakeholders have the information they need in seeking to balance the same concerns within their investments, their purchases and their political spheres of influence.

### **Evolving Assurance**

Determining what issues are likely to be material to the long-term success of corporate strategy is clearly the business of the company itself, not its auditors. But ensuring that decision makers have the information they need about issues that matter to them requires not only acceptable methods, but ways to make sure that they are being robustly applied. Assurance providers therefore are being asked to attest not only to the technical quality of reported data in relation to information users' needs, but to the substantive question of whether all the issues that are significant are sufficiently covered, and whether the organisation has sound systems for identifying emerging issues.

The value and practice of financial auditing, developed and refined over many decades, has depended on well-defined user groups and a clear articulation of what is material to them. Therefore the application of conventional approaches of assurance to the wider matter of sustainability has not been straightforward. The mainstream audit community has struggled to upgrade their core methodologies, competencies and institutional cultures and orientations to suit this newly-emerging assurance market. In particular, assurance providers within these traditions have tended to be more comfortable in focusing on questions of the technical quality of reported

data (its veracity, accuracy and completeness) than on the substantive questions of informative materiality.

The demand for and practice of sustainability assurance is clearly still evolving and much debate is taking place on the appropriate approaches and their fit with specific contexts or assurance appetites. What is clear is that neither traditional audit methods that focus on the accuracy of historic data nor those that only focus on issue materiality will be sufficient to secure confidence and enable good decision making.<sup>32</sup>

## 6. Conclusion

---

If businesses are going to succeed in understanding and shaping their environment in a way that addresses urgent sustainable development challenges, they need a rigorous approach to materiality which can direct, rather than just reflect performance. The Materiality Framework outlined here, based on *clear and transparent* criteria, *inclusiveness* in engagement with stakeholders, *alignment* with corporate strategy and *embeddedness* in decision making structures, offers the basis for such an approach. It is compatible with leading standards such as the Global Reporting Initiative G3 Guidelines, the AA1000 Assurance Standard and ISAE3000.

A rigorous and useable materiality lens on sustainability issues can enable:

- ❖ **managers to make decisions in line with long-term objectives** without being hamstrung by an overwhelming focus on the more clear-cut short-term financial, compliance or technical goals.
- ❖ **investors, partners and other financial stakeholders** to direct their financial and organisational capital towards businesses that can demonstrate they are fit for the future.
- ❖ **governments, civil society and other stakeholders** to have a clear picture of which issues businesses are taking seriously, which would make them better able to target criticism, reward, regulation or contracts.

Of course no framework can be effective simply as a mechanistic tool. Insightful judgement and good leadership remain crucial. Materiality drives performance by highlighting the issues that are likely to be

important now and in the future, and putting this information in the hands of the business leaders, managers and stakeholders with the power to direct business strategy and influence actions.

Focusing the materiality lens on those sustainability issues that could drive business strategy and performance is the most effective way to test businesses' real commitment to the sustainability imperative. Businesses that deem issues to be immaterial that the majority of stakeholders consider important are revealed as not having an embedded response. The 'gap' thus illuminated between issues considered important and those seen to be material is a measure of a business' will and capability to truly respond to what stakeholders think should count. The movement of issues, such as climate change or human rights, from the category of 'important but immaterial' to 'important and material' is, similarly, a measure of progress of business in reshaping their success models to deliver sustainability outcomes. Real business leaders, those who have 'got it', can be distinguished from those who are still primarily focused on avoiding problems.

Advancing this approach to materiality has one additional, crucial implication in opening the way to a progressive integration of sustainability and financial accounting, assurance and reporting. Much of today's traditional and regulated corporate disclosures fail to illuminate businesses' underlying, longer-term prospects. The Materiality Framework set out in this report, based on emerging sustainability practices, metrics assurance and reporting may provide the missing link. The Framework extends the scope of measurement and reporting, to issues and performance drivers that are not yet manifested in market opportunities or risks, and have not yet been

---

translated into products and processes let alone financial transactions. Focusing the lens of materiality as proposed is the means by which the basis of

mainstream financial assurance and reporting will absorb, or else be absorbed into, the sustainability agenda.

### **Moving Forward**

This report and Materiality Framework has been developed through the cooperation of leading businesses, assurance providers, research networks and standards developers, and it is these same actors which have a large part to play in pushing forward developments in materiality:

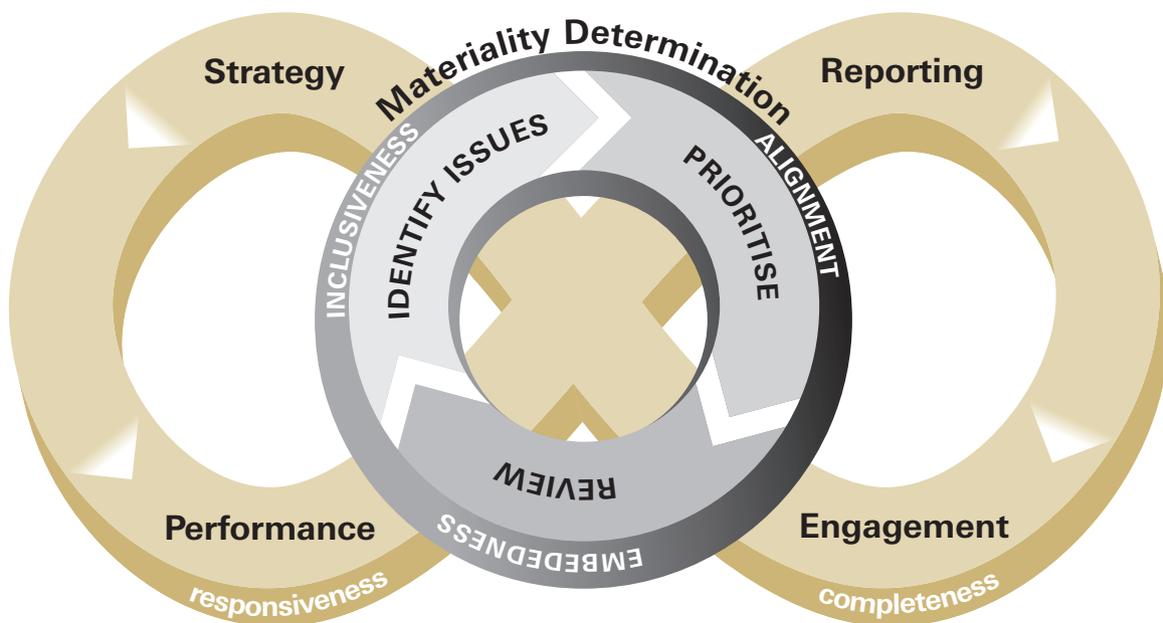
- ❖ **Businesses can build on the materiality concepts and processes** outlined here and contribute their experience to the open source development of an evolving Materiality Framework.
- ❖ **Assurance providers will need to develop their approaches and competencies** to attest to both the strength of a business's materiality assessments as well as the quality of information reported.
- ❖ **Research and learning networks should continue to analyse and support ongoing developments in the practice of materiality** by businesses and assurance providers.
- ❖ **Standards bodies can build on this experience to develop clearer guidance** on materiality determination and the links between issue materiality, information users and information quality.

Crucially, ongoing development, research and dialogue should bring together learning from the field of sustainability reporting with developments in risk assessment, internal assurance and financial reporting.

---

**The challenge of sustainable development requires business to shift from viewing it as a matter of compliance to one of value generation.**

Businesses therefore need a robust and usable method for working out what is material, and for communicating this credibly within the business and to investors and other stakeholders.



**The Materiality Framework** outlined in this report is a practical and rigorous approach to determining the strategic significance of social and environmental issues

- ✓ It is based on the real practice of leading businesses.
- ✓ It puts the business significance of sustainable development issues at the centre of corporate responsibility thinking.
- ✓ It can be used to inform strategy development as well as reporting.
- ✓ It is compatible with leading standards such as the GRI G3 Guidelines, the AA1000 Assurance Standard and ISAE3000.

## References

---

- 1 There are significant differences between the pressures and time horizons on organisations with investors and customers, to those with voters and citizens, political masters and statutory clients, or funders and beneficiaries. AccountAbility Forum (Issue 11- Autumn 2006) looks more widely at materiality practices across different sectors. <http://www.greenleaf-publishing.com/af/afframe.htm>
- 2 This is a phrase coined by CK Prahalad and Stu Hart in 2002 to describe the opportunities for businesses to successfully market to the 4 billion consumers with less than \$5 per day to spend. The Fortune at the Bottom of the Pyramid. Prahalad, C.K. and Hart, S.L. "The Fortune at the Bottom of the Pyramid", Strategy and Business, Fall 2002.
- 3 Time Magazine (2005) Getting Smart at Being Good ... Are Companies Better Off for It?, Monday, Dec. 12, 2005. <http://www.time.com/time/insidebiz/printout/0,8816,1139825,00.html>
- 4 See for example, General Motors: <http://www.gm.com/company/gmability/workplace/index.html> or Volvo: <http://www.volvo.com/group/global/en-gb/Volvo+Group/our+companies/volvotechnologycorporation/votecabout/>
- 5 Context (2006) Global Corporate Responsibility Reporting Trends [http://www.econtext.co.uk/cover\\_scans/InContext2006.pdf](http://www.econtext.co.uk/cover_scans/InContext2006.pdf)
- 6 Forstater, M and Raynard, F (2002) CORPORATE SOCIAL RESPONSIBILITY; Implications for Small and Medium Enterprises in Developing Countries, UNIDO, Vienna. <http://www.unido.org/userfiles/BethkeK/csr.pdf>
- 7 Knight, P (2005) Foreword to Corporate Responsibility Report FY04, Nike Inc.
- 8 AccountAbility/CSR Europe (2002) Impact of reporting, AccountAbility, London.
- 9 AccountAbility (2006) The Future of Transparency (forthcoming).
- 10 See for example AccountAbility (2002) The Impact of Reporting, Pleon (2005) Global Stakeholder Report 2005 and Sustainability/UNEP (2002) Trust Us: The 2002 Global Reporters Survey of Corporate Sustainability Reporting.
- 11 S&P/UNEP/Sustainability (2004) Risk & Opportunity: Best Practice in Non-Financial Reporting The Global Reporters 2004 Survey of Corporate Sustainability Reporting.
- 12 Quoted in Pleon (2005) *op cit*.
- 13 Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, Financial Accounting Standards Board (FASB).
- 14 The EU Emissions Trading Scheme definition of materiality states that: "*whether an individual or aggregation of omissions, misrepresentations or errors that affects the information reported for an installation will reasonably influence the intended users' decisions. As a broad guide, a verifier will tend to class a misstatement in the total emissions figure as being material if it leads to aggregate omissions, misrepresentations or errors in the total emissions figure being greater than 5 percent. An emissions report and related disclosures shall be free of material mis-statement, avoid bias in the selection and presentation of information and provide a credible and balanced account of an installation's emissions*"
- 15 AccountAbility (2006) What Assures? AccountAbility, London.
- 16 AccountAbility/World Economic Forum Roundtable on Investment quoted in Zadek (2006) The New Competitiveness, Harvard Business School. (forthcoming).
- 17 Graham et al. (2004) "The Economic Implications of Corporate Financial Reporting", Duke University, Durham
- 18 SustainAbility (2004) Video interview by John Elkington of George Dallas. <http://www.sustainability.com/insight/article.asp?id=278>
- 19 AccountAbility 2003 AA 1000 Assurance Standard.

- 
- 20 The key difference between the AA1000AS and the IAASB approach is that the IAASB empowers the reporting organisation to pre-define what is and is not covered in both the report and in what is to be assured, whereas AA1000AS requires the assurance provider to have a duty of care to the intended readers of the report in assuring the report on the basis of what is material to them. A joint study by AccountAbility and KPMG, Assurance Standards Briefing: AA1000 Assurance Standard and ISEA3000 compares the two standards.
- 21 Scott, L (2005) Speech presented by Lee Scott October 24, 2005  
<http://www.walmartstores.com/Files/21st%20Century%20Leadership.pdf>
- 22 <http://www.globalreporting.org>
- 23 [http://www.btplc.com/Societyandenvironment/magazine/material\\_world.htm](http://www.btplc.com/Societyandenvironment/magazine/material_world.htm)
- 24 <http://www.btplc.com/Societyandenvironment/SocialandEnvironmentReport/section.aspx?sectionid=b8915e10-5f32-475a-90bb-a7b9b80a6170>
- 25 See for instance Shell 's External Review Committee, and Nike's Report Review Committee. A forthcoming report by AccountAbility and Utopies explores the recent development in stakeholder panels to understand how panels work, what makes them effective and what challenges they face going forward.
- 26 Context (2006), Corporate Responsibility Reporting Trends: Reporting in Context 2006.
- 27 Nike does employ various types of third party data verification on particular performance areas within their report to add integrity of the data presented, but do not employ an overall verification process at present. Maplecroft's discussion of Nike's report can be downloaded from <http://www.maplecroft.com/pdf/nike2004.pdf>
- 28 IASB (2005) Discussion Paper on Management Commentary, International Accounting Standards Board,  
<http://www.iasb.org/NR/rdonlyres/0FE78C14-8AF9-4CFB-A764-40B1A08E0DF5/0/DPManagementCommentary.pdf>
- 29 *Ibid.*
- 30 For example, BSR (2005) Reporting as a Process: A Briefing by Business for Social Responsibility for the Global Reporting Initiative [http://www.bsr.org/Meta/BSR\\_GRI\\_ReportingProcess\\_2005.pdf#search=%22materiality%20threshold%20ibm%22](http://www.bsr.org/Meta/BSR_GRI_ReportingProcess_2005.pdf#search=%22materiality%20threshold%20ibm%22) depicts the sustainability materiality threshold as explicitly less important than the financial threshold. Context (2006) Global Corporate Responsibility Trends 2006 calls them arbitrary lines.  
[http://www.econtext.co.uk/cover\\_scans/InContext2006.pdf](http://www.econtext.co.uk/cover_scans/InContext2006.pdf)
- 31 Bamford, J and Ernst, D (2005) Governing joint ventures: Better oversight isn't just for wholly owned businesses in The McKinsey Quarterly 2005 Special Addition on Value and Performance.
- 32 AccountAbility (2005) What Assures, AccountAbility, London. AccountAbility's most recent work on assurance "People Centred Assurance" (with KPMG Netherlands) reports on emerging practice and aims to assist Assurance Practitioners in providing meaningful and effective assurance which puts intended users at the centre of the assurance process.(forthcoming).