

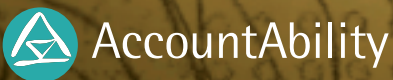
The Materiality Report

Aligning Strategy, Performance and Reporting

A Briefing



November 2006



In association with



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 some stakeholders require, while still being able to show what's really important to the success of the organisation. And 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.

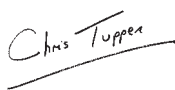
As we travelled this journey it became increasingly clear to us that the benefits of a robust materiality determination process go far beyond reporting. It provides the organisation with evidence that links sustainability to commercial strategy, helps identify longer term value drivers and is a route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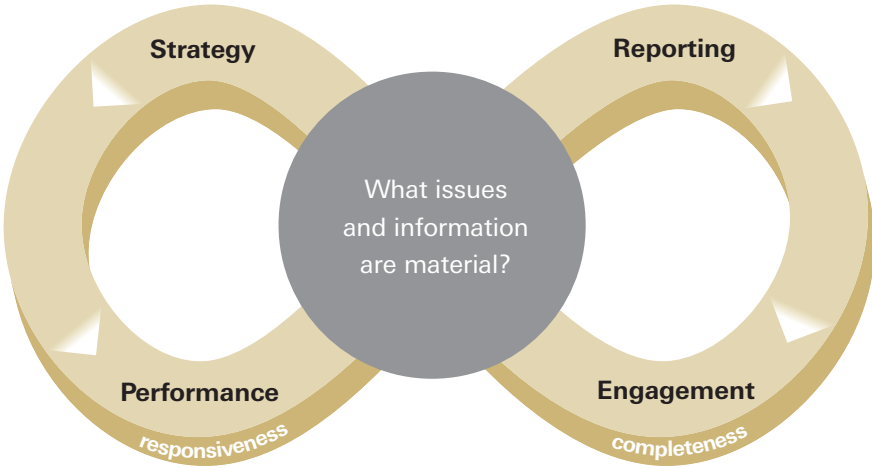


Deborah Evans
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In Brief

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

To achieve this, businesses will need to align their strategies and performance management to emerging social and environmental constraints and opportunities. 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*.

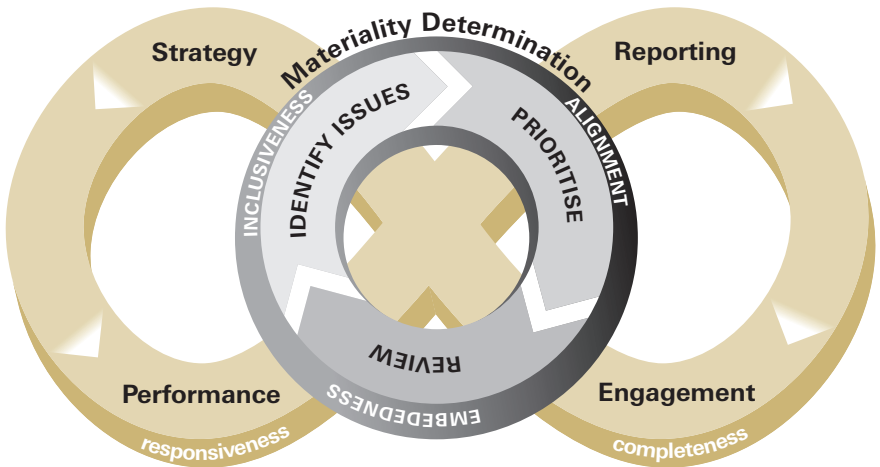


Businesses need to work out what is material, and articulate this in credible ways in order to drive learning and innovation.

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 others 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, and so drive business strategy and performance.
- ❖ **Communicators and assurance providers** to ensure that sustainability performance reporting focuses on material issues and enhances the value of both reporting according to leading reporting and assurance standards such as the GRI G3 Guidelines, the AA1000 Assurance Standard 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.

1. Material World

Businesses navigate through an ever shifting world of competitive, technological, societal and regulatory change. In order to respond better and faster they need to be open to learning from diverse sources. But they also need to be able to sort out what is material from what is 'noise'.

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

There is no clear threshold of legal, financial or reputational liability below which businesses can safely say 'that is not our problem'. Emerging issues may be contested and difficult to measure, but they can be early signs of growing risk or opportunity. More established societal issues become an accepted part of doing business. But whether they are seen as a cost of business or as value drivers depends on whether the business can shift its view of sustainable development challenges from compliance to value creation.

What Might be Material?

AccountAbility's '5 part materiality test', proposed in 2003 and embedded into the AA1000 Assurance Standard calls on businesses to identify issues that are relevant to:

- ❖ Direct short-term financial performance;
- ❖ The business'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.

Not all these issues will turn out to be significant to long-term success. Businesses need to be able to prioritise in order to align their approach to social and environmental issues with their strategy, practices and ultimately performance.

Reporting what matters

Companies seeking to align their response to social and environmental

challenges with their business strategy or indeed to reinvent their underlying business model, need to be able to communicate this to their investors, as well as to other stakeholders who can influence their success. Stakeholders with an interest in investing their financial or organisational capital in businesses that are managed for the long term need to be able to confidently identify those businesses that don't just 'toe the line' or 'talk the talk', but 'walk the walk' of sustainability.

Material information enables stakeholders and management to make sound judgements and take action which influences the organisation's performance

The concept of materiality has traditionally been used as the basis on which management provides a corporation's owners with financial information. More recently the idea has been pressed into service to try to assess what should be included within wider 'non-financial' and sustainability reports. Neither approach has proved effective in picking up on the drivers of long term business transformation:

- ❖ **Traditional assessments of materiality focus too narrowly** on timescales, stakeholder interests and business actions that impact on short-term performance.
- ❖ **Stakeholder driven sustainability reporting argues for compliance** with an ever-expanding set of disclosure requirements as evidence of conformity with laws, norms, codes, and commitments.

Redefining materiality

Companies have to be responsive to compliance demands and reasonable disclosure requirements. But the most important role of business in addressing sustainable development lies in what it does, not what it avoids doing. Therefore, a new approach to materiality is needed which still focuses on what is important *to the business*, but which uses a wider lens, in order to capture:

- ❖ a **longer term view of the issues** that could affect the success of business strategy;
- ❖ a **wider view of the people** whose actions influence performance,

-
- and who therefore need sound information to guide their judgements;
- ❖ 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.

This approach to thinking about materiality does not push stakeholders out of the spotlight, but does stay focused on how their interests, concerns and actions relate to performance.

An emerging common approach to materiality

A few pioneering businesses including BP, BT, Ford and Nike, have begun to develop a rigorous practice for determining and communicating their approach to materiality. We have used this to build a more generally applicable Materiality Framework which can be used by others to ensure that strategy development, performance management and public reporting are focused on the issues that matter.

Governments, regulators and international accounting bodies are also increasingly looking at the question of how corporate reports can better reflect forward-looking strategies, risks and opportunities. In particular, they recognise the need for more guidance and regulations relating to the 'narrative' reporting accompanying financial statements. Significant recent developments include modernisation of EU accounting directives and the ongoing development within the accountancy community of standards for assurance of non-financial information.

The Framework outlined here has been designed to enable businesses 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 ISAE 3000, The GRI G3 Guidelines and the AA1000 Assurance Standard.

It is intended as a basic foundation which businesses can tailor to meet their needs and those of their stakeholders and information users.

2. The Materiality Framework

Design Principles for a workable materiality methodology

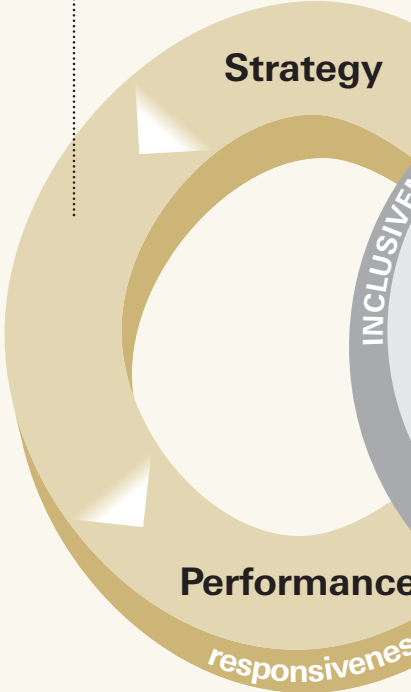
It needs to be able to:
Identify and prioritise issues for action according to the degree of significance to the business and its stakeholders.
Determine what information is most useful and meaningful.
It should be based on:
Broad-based research and engagement with stakeholders
Strong alignment with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

Use to inform future strategy:

- ❖ Constraints
- ❖ Opportunities

Stage stakeholder

- ❖
- ❖
- ❖
- ❖
- ❖



Stage 3: Embed process in internal decision and external review

Ideally process should be subject to

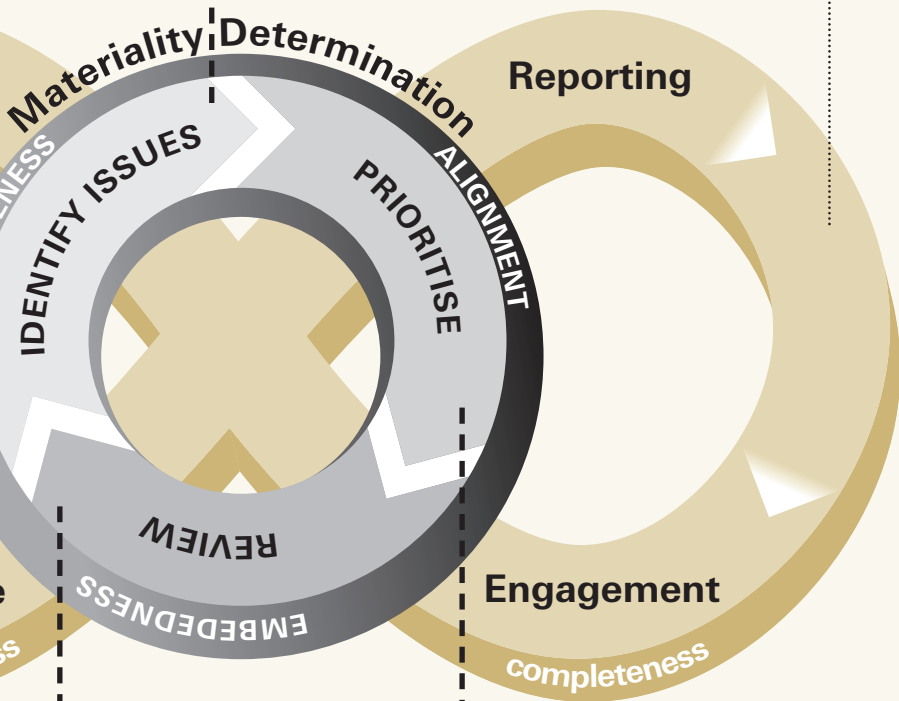
- ❖ review by internal and external advisors
- ❖ sign-off at board level
- ❖ independent assurance as part of overall process.

1: Identify issues from a wide range of holders and sources

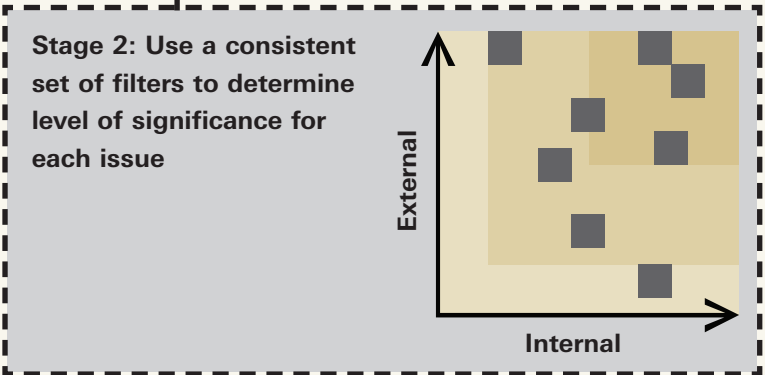
Business strategies, reports, risk register
 Company policies and commitments
 Best practice norms exhibited by peers and highlighted in relevant standards;
 Stakeholder feedback and engagement
 Public debate in the media, campaigns, parliament etc...

Use as the basis for publishing information on:

- ❖ Policies
- ❖ Actions
- ❖ Performance



Decision making
 Advisory panels
 Overall reporting



Stage 1: Identify issues

Inclusively identify issues that are, or could be, relevant to the business and its stakeholders, and collect the information needed to assess their significance.

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.

Draw on internal and external sources of information including stakeholder engagement, and scientific knowledge about environmental limits, to identify issues relevant to existing strategies, policies and performance management and those which might pose new risks and opportunities.

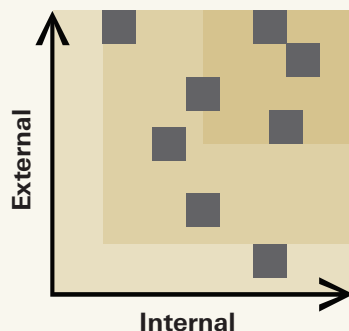
Stage 2: Prioritise

Assess the issues according to how significant they are and identify what action and information is needed to drive performance.

Choose internal and external criteria to identify issues relevant to the drivers of commercial performance and issues considered important by the stakeholders who matter most to the business.

Decide on thresholds to divide the map into zones of materiality. Essentially, these are the thresholds which indicate whether an issue is considered significant enough to require corporate action (and at what level) and whether it is significant enough to provoke stakeholder action (and at what level).

Use the criteria, thresholds and evidence to prioritise each individual issue - this may be through a qualitative analysis and discussion or a scoring system. Most businesses 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.



NB: At each stage the process should be documented to facilitate analysis and assurance

Stage 3: Review

Ensure that the basis of materiality determination is considered sound and credible both internally and externally and that its implications have been considered.

Throughout the process the implementation team should review the information sources, data and analysis, seeking further information as necessary, from stakeholder sources and internal points of expertise and accountability.

Internal and external review will strengthen the outcome of the process. Businesses should ideally include the materiality determination process within the scope of internal and external review panels, board level sign off and independent assurance processes.

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.
- ✓ **To promote internal understanding of the link** between sustainable development issues and business strategy.
- ✓ **To feed into ongoing strategy development** by highlighting rapidly emerging issues and enabling them to be factored into strategy development.

The basic methodology can be adapted to identify issues related to different areas of internal significance, or to analyse the implications of taking longer time horizons into accounting, planning and reporting.

This is an abridged version of the Materiality Framework included within The Materiality Report, which can be downloaded from www.accountability21.net/materiality.

Materiality Futures

The State of Leading Practice

This new materiality determination approach meets the pressing need to focus the content of sustainability reports on strategic issues and performance. Perhaps more importantly, it has enabled issue experts to better understand and speak the language of business and has engaged senior strategic and operational managers in understanding the business implications of emerging sustainable development issues. It 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. However, businesses can apply this basic Materiality Framework in ways that go beyond reporting to informing the development of strategy. 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.

Future Developments

Key challenges will need to be tackled in developing an approach to materiality which closes the loop between reporting and stakeholder engagement on one side, and strategy development and performance management on the other. These include:

- ❖ **Developing greater clarity and transparency of criteria and thresholds** – Providing more clarity as to the basis of materiality determination would give more credibility to businesses' approaches to social and environmental issues. 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 assurance.
- ❖ **Integration with mainstream materiality** – When material sustainability issues are checked against traditional corporate risk

thresholds they often do not pass the conventional short-term financial tests of materiality and are therefore seen to be *less* important. However, what should be made clear is that the spectrum which separates these different thresholds of materiality is not one of *decreasing importance*, but of *increasing time*. Clarity about the time horizons which underlie the thresholds used in materiality assessments would provide a clearer basis for investors and other external stakeholders comparing different businesses' approaches to long-term sustainability. It would also provide a clearer basis for integrating these issues into strategy development processes.

- ❖ **Linking material issues with information requirements** – Current materiality methodologies tend to yield three basic conclusions: to emphasise, include or omit issues in reporting. Businesses will need to go further in using materiality criteria to assess specific user information needs (both internally and externally). This would help to ensure greater alignment between this overall assessment of issue materiality, the provision of meaningful data and influence on performance levers.
- ❖ **Materiality and governance at the boundaries** - One clear challenge is in deciding where to draw the line of responsibility in relation to joint ventures and contractual relationships. Both GRI and AA1000AS provide some guidance: making clear the principle that material issues are not only confined to areas of direct corporate control. This is not a question which can be addressed purely through methodological guidance, but calls into question how standards of corporate governance and transparency are extended to joint ventures.
- ❖ **Assurance** - Neither traditional audit methods that focus on the accuracy of historic data nor those that only focus on issue materiality will be sufficient alone to secure confidence and enable good decision making. The practice of sustainability assurance will need to continue to evolve in order to develop appropriate approaches to specific contexts and assurance appetites.

Concluding remarks

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 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

Leading businesses, assurance providers, research networks and standards developers have an important 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 methodology.

Assurance providers will need to develop their approaches and competencies to attest to both the strength of a business's materiality determination processes as well as assessing the quality of information in reporting.

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.

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The Materiality Framework is based on the approaches and experiences of businesses including Anglo American, Ford Motor Company, The Gap Inc., Hydro Tasmania, Nike Inc, Novozymes, BT Group Plc, BP Plc and Telefonica. Leading thinkers and practitioners from the world of reporting, assurance and standards development also provided comments on various drafts.

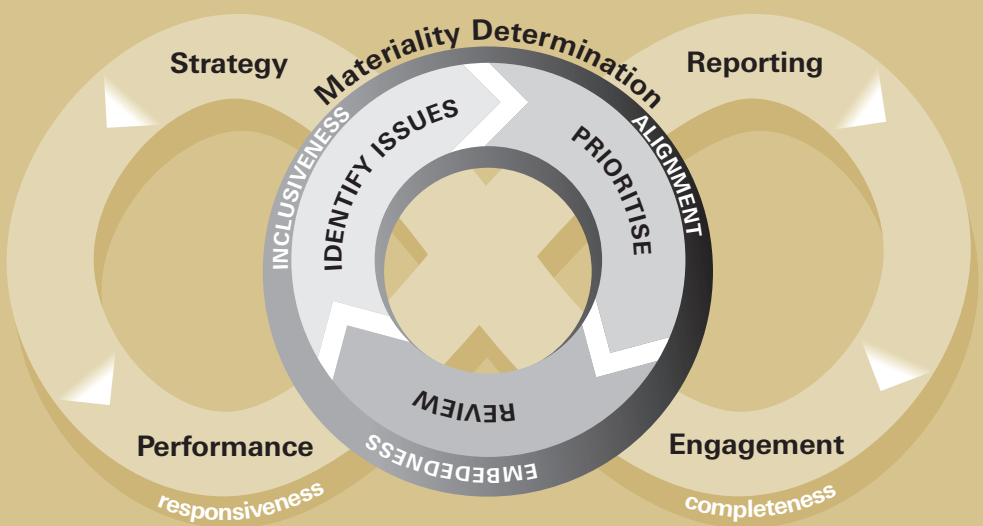
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The challenge of sustainable development requires business to shift from viewing it as a matter of compliance to one of value generation.

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 briefing is a practical and rigorous approach to determining the strategic significance of social and environmental issues.



- ☑ It is based on the real practise 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.

The full Materiality Report can be downloaded from www.accountability21.net/materiality