
Materiality Determination

Analysing who, what and how

FRONESYS

A FRONESYS WHITE PAPER

by

Chris Tuppen

October 2011

1. Introduction

The context: materiality joins sustainability to business strategy

Traditionally, business strategy has been about issues such as growth, profitability, competitive position and returns to the shareholder. While business leaders need to continue to focus on exactly these issues, what has changed around them is the context in which they operate.

It is the very success of business based on these principles which has created, across just one lifetime, the tremendous change and explosive growth that has transformed life for many - but not all - across the globe. But all this growth has come at a cost. We now understand, better than ever before, that human behaviour is driving climate change, short-term thinking has left us with a global recession, and we are faced with unprecedented resource shortages.

As a result, business leaders are learning that focusing on sustainability is essential: companies that manage their economic, social, environmental and ethical performance also maximise their financial performance and long-term value creation. Best practice business strategy is increasingly about transforming global sustainability challenges into business opportunities.

But how does the contemporary business strategist decide which issues to focus on, particularly when sustainability has not been part of mainstream strategic thinking for many?

For companies that have not started this journey, there is much to do simply establishing the facts regarding sustainability in the firm, getting the conversation going among managers, laying out a grammar and vocabulary for assessing sustainability performance, and building that understanding into their performance measures, systems and processes. For those companies that have passed this first base, few have gone as far as integrating their traditional approach to business with the sustainability imperative.

For all companies, getting the process of materiality assessment is critical because correctly identifying their material issues creates a successful and essential link between strategy and sustainability. And integrating sustainability into the business is a necessary precursor to integrated reporting.

This white paper summarises the findings of recent Fronesys research into how a selection of 31 leading companies have assessed their material sustainability impacts and evaluates how the processes and metrics they use can be improved.

Those interested in the accompanying data sets, and a fuller research analysis, can find these in **Materiality Futures**, a report that can be purchased from Fronesys (check out www.fronesys.com) and will allow any company to:

- compare their own materiality rankings against published data for 50 separate sustainability issues;
 - identify which issues have a general agreement on materiality levels across sectors and geographies, and where there are large variances;
 - see the extent to which, for each of the 31 companies surveyed, the stakeholders and company align in their opinions
 - see what stakeholder and business inputs have been used to weight issues;
-

- understand the strengths and weaknesses of the current approach;
- learn how materiality feeds into the new International Integrated Reporting Committee (IIRC) reporting framework.

2. Materiality Determination

The use of a materiality determination process has certainly brought a clearer focus to sustainability reporting, with leading reporters disclosing better linkages between sustainability indicators and their company’s primary business objectives. The underlying approach, first articulated by AccountAbility with the collaboration of this report’s author, and then applied to GRI’s guidelines, is widely adopted and appears to be quite workable, although it does have inherent limitations.

When it comes to intangible asset valuation, sustainability issues that are initially non-material from a financial point of view can quickly become material to a business if their wider stakeholder community deems them to be significant. Thus, in determining materiality from the sustainability perspective, most organisations consider a broad mix of views. The results are often presented graphically, as in Figure 1, with a “stakeholder” axis (usually the vertical axis) and a “company” axis. They may also be presented as a two dimensional matrix in tabular form. Either way, the most material issues appear at the top right hand corner. We have used the term materiality matrix to cover both graphical and tabular formats.

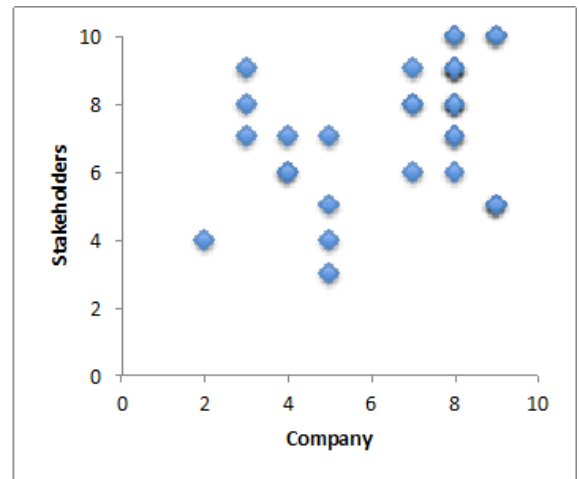


Figure 1: A typical materiality determination matrix, charting the importance of an issue to a com-

Researching materiality

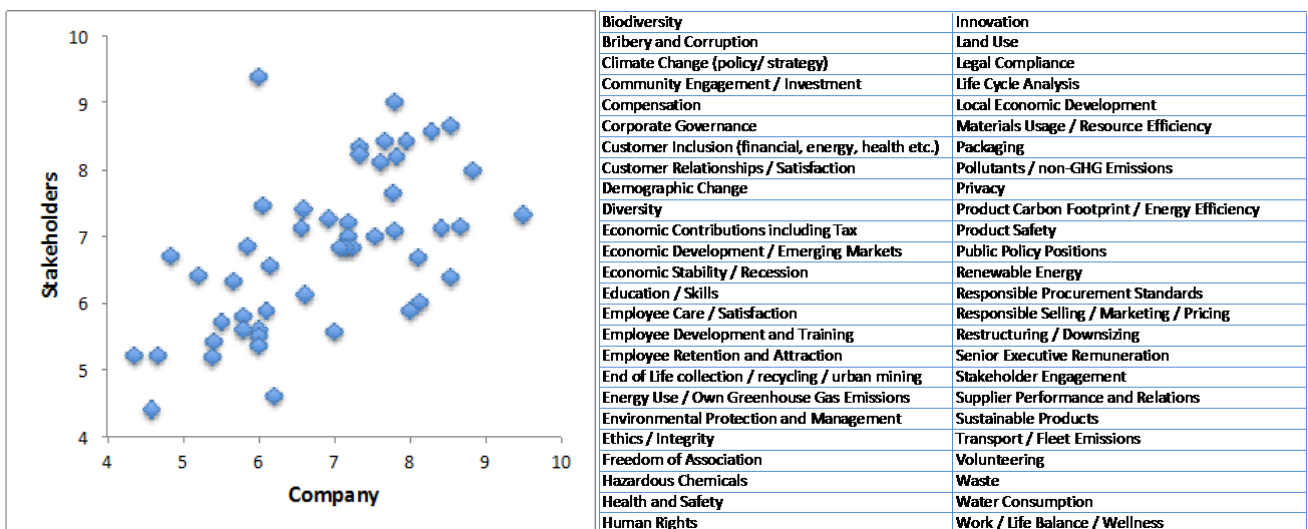


Figure 2: The matrix of matrices charts the 50 leading sustainability issues, as reported by 31 leading international companies.

Although many companies respond to GRI indicator 3.5 and say they use a materiality determination process, relatively few disclose much detail on the determined level of materiality for individual sustainability issues. The 31 companies in this study represent the exception and our review is based on their sustainability reports published before 1 August 2011. Each company was assessed against its materiality matrix and associated narrative. All the companies assessed aligned one axis to the company and the other to its stakeholders. In most cases the horizontal axis related to the company and the vertical to its stakeholders. A few companies make reference to a third dimension related to the ability of the organisation to influence the outcome of the issue in question.

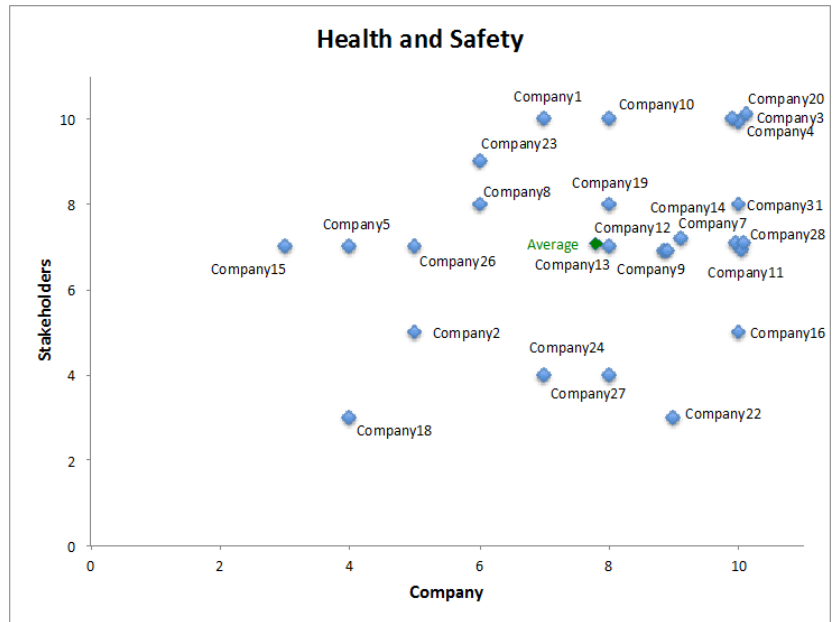


Figure 3: An example of a materiality scatter chart showing how different

In total, nearly 140 separate issues were recorded from the 31 companies surveyed. As a general categorisation they could be split between economic, governance, environmental, social and global trends. While many issues were generic across all sectors, some were quite sector-specific.

The 50 most commonly referenced issues were consolidated as a 'matrix of matrices'

- ◆ Oil and Gas
- ◆ Financial Services
- ◆ ICT
- ◆ Real Estate

of average materiality scores, as in Figure 2. Attribution of each issue to its relevant point on the matrix of matrices is provided in the **Materiality Futures** report..

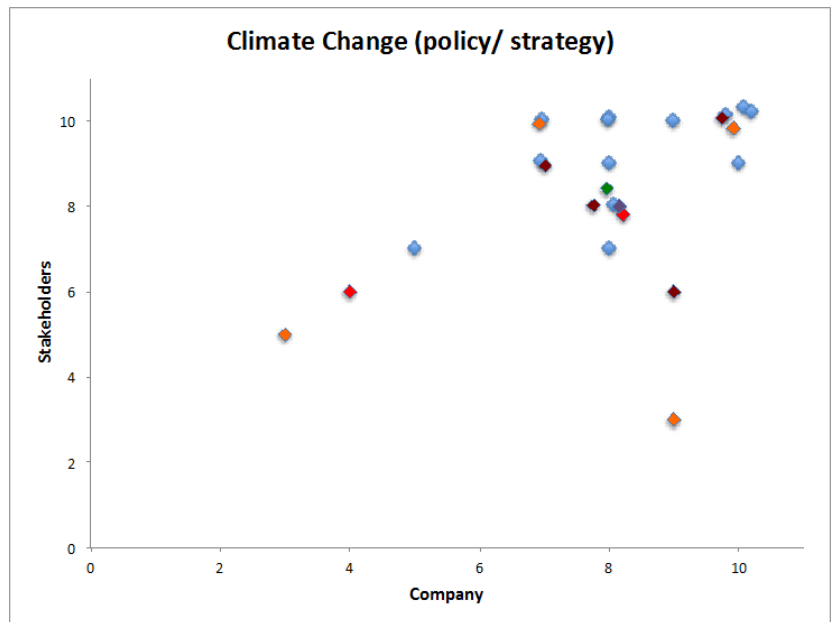


Figure 4: A further example of a materiality scatter chart showing how different companies positioned Climate Change issues. A few specific

A materiality scatter chart for each of the 50 most referenced issues with actual company identification is provided in the full report. For every chart the materiality level determined by each company is shown, as well as the average materiality level. Health and safety provides a typical example of such a scatter chart, as in Figure 3.

Climate change policy and strategy is another, in this case with a few specific sectors identified.

Materiality metrics

The extent of scatter of points across an issue chart indicates the degree of **materiality coherence** between companies. Fronesys therefore proposes a new metric called the Issue Coherence Level (ICL). A high coherence implies that most companies and their stakeholders agree on their respective levels of materiality significance. On the other hand, a low coherence suggests a wide disparity of views. Out of the 50 most referenced issues, the impact of the recession and need for economic stability showed the highest level of coherence, and biodiversity the lowest. One might think that even where there are low levels of coherence across all companies there might be general agreement within a specific sector. But even this is often not the case, reinforcing the observation that, when it comes to materiality, in some instances such as biodiversity people just don't know! Check out Figure 5 for the biodiversity materiality scatter chart.

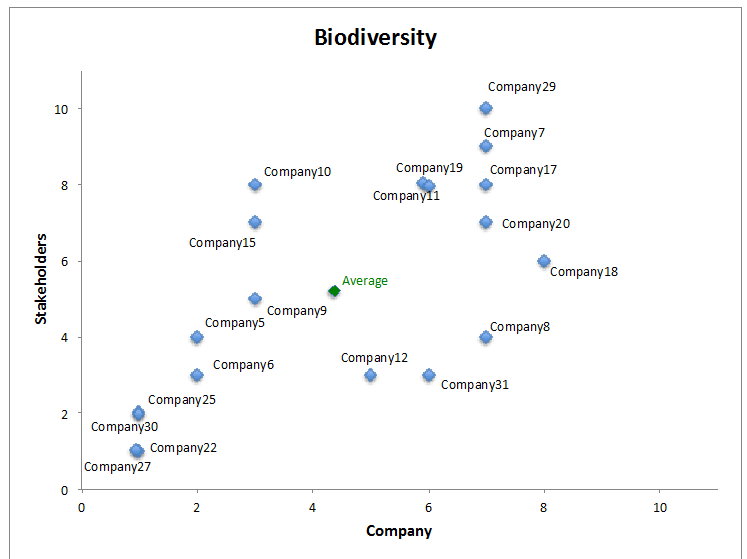


Figure 5: A biodiversity materiality scatter chart demonstrates the spread across companies when it comes to opinions on a difficult issue.

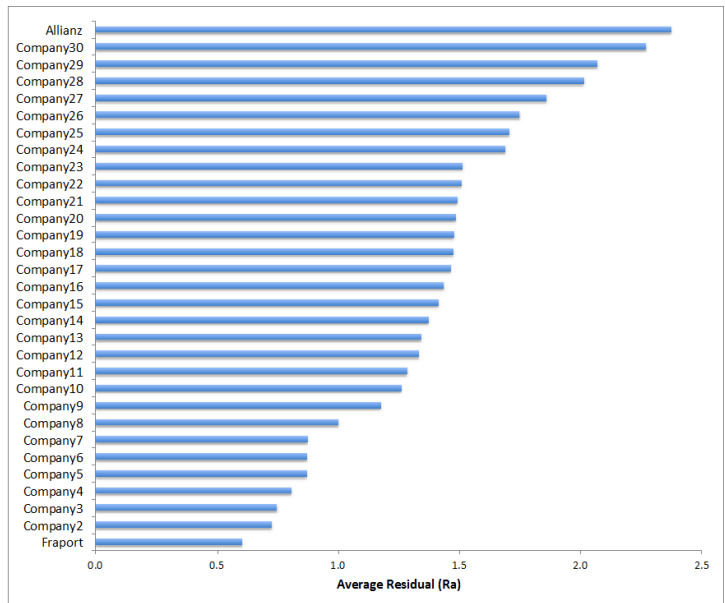


Figure 6: Average Residual explores the convergence of opinion between stakeholders and the company on all issues. In this example, Fraport shows great convergence of opinion with its stakeholders.

Fronesys also proposes a second new metric known as the **average residual (Ra)** which, for a given company, indicates the level of convergence in the significance of issues between a company and its stakeholders. The higher the convergence, the lower Ra, with Ra = 0 indicating perfect convergence. Of the companies surveyed, Fraport showed the highest convergence of opinion between itself and its

stakeholders and Allianz the lowest. This leads one to ask if there is an optimum degree of convergence. Certainly it would seem extremely odd for a company to be entirely in tune with its stakeholders, so a very close convergence (low R_a) should raise questions. Equally a total lack of convergence could suggest the company is out of touch. The full **Materiality Futures** report provides disclosure of R_a for all 31 companies.

3. Connecting strategy to sustainability

The level of detail covering the underlying process of materiality determination is very variable. Many companies simply refer to external guidance, whilst others offer substantially more information.

Based on published data we have reviewed the range of inputs used to evaluate the level of significance along both the stakeholder and company axes. We find that, in the main, companies disclose much more detail about the stakeholder aspect than the internal company process. GRI G3.1 guidelines core indicator 3.5 requires organisations to disclose their process for determining materiality, and one might expect that companies declaring higher levels of GRI reporting performance would be more explicit with respect to materiality. However, this proves not to be the case and the levels of disclosure around materiality vary significantly and show little relationship to the GRI ‘application levels’.

Many of the companies surveyed make it very clear that the results of their materiality determination process guide their sustainability strategy. Only a very small minority say that the materiality analysis impacts went beyond sustainability management and actually had a direct influence over their main business strategy.

However, many questions around strategic alignment are often left unanswered. In particular:

- should an issue deemed to be material in a sustainability matrix automatically be considered material under a more conventional accounting approach?
- if not immediately, over what frame might this be expected to happen, if at all
- should sustainability and traditional accounting and accountability remain separate or be combined into an integrated process?

These questions, and most particularly the last one, may be answered by the growing interest in integrated reporting.

Integrated Reporting

Integrated reporting seeks to consolidate a company’s traditional business performance reporting with its non-financial reporting. The International Integrated Reporting Committee (IIRC) discussion paper *Towards Integrated Reporting - Communicating Value in the 21st Century* proposes a principle-based approach. The five underlying principles are strategic focus; connectivity of information; future orientation; responsiveness and stakeholder inclusiveness; conciseness, reliability and materiality.

It is hoped that the IIRC framework will not only lead to a consolidation of the reporting of the most material issues, but also lead to more forward looking reports that illustrate a strategic alignment

between sustainability and conventional business objectives. For any company adopting the IIRC framework the process of materiality determination will need to be at the core of their thinking.

4. Summary of Observations and Next Steps

In summary, the Fronesys analysis has shown that the generally used materiality determination approach, first defined by AccountAbility in 2006, is both workable and useful, and that there is general agreement across industry sectors on a wide range of the most material sustainability issues.

However, the analysis has also highlighted a number of anomalies and shortfalls; in particular the fact that most companies still disclose no more than tentative linkages between materiality in the sustainability context, and their commercial business strategy.

With the advent of integrated reporting it will be important to strengthen and combine sustainability and traditional business materiality determination. This should strengthen the need for greater transparency on how the output of the materiality process has influenced the overall, long-term strategic thinking of the company.

Recommendations

The use of a materiality determination process has certainly brought a clearer focus to sustainability reporting, with leading reporters disclosing better linkages between sustainability indicators and their company's primary business objectives. The underlying approach, first articulated by AccountAbility, is widely adopted and appears to be quite workable, although it does have inherent limitations.

In order to improve things still further the following recommendations are made.

Companies should be encouraged to:

- adopt a materiality process, if one is not already in place;
- publish a quantified and populated materiality matrix;
- disclose the underlying process and scoring mechanisms;
- review results against peers to avoid inexplicable anomalies;
- provide much more detail on how company impacts are assessed;
- converge sustainability and business materiality assessments;
- investigate supplementary data feeds;
- consider full life cycle impacts; and
- work towards an integrated reporting platform

In addition GRI should specify more detailed disclosure requirements around the outcomes and process, especially at higher GRI attainment levels.

Companies analysed in the *Materiality Futures* report include:

Allianz
AT&T
Ball Corp
Bayer
BMW
Cisco
Daimler
Danisco
Delhaize
Deutsche Telekom
ENI
EON
Fraport
Ford
Friends Life
Intel
L'Oreal
Ontario Realty
Petrobas
Rio Tinto
Salzgitter
SAP
Siemens
Staples
State Street
Symantec
TUV Rheinland
Vodafone
Volkswagen
Westpac
Wipro

Materiality Futures is a report from Fronesys that contains a full analysis of materiality determination, based on the principles and metrics laid out in this report. It analyses the public disclosures on 50 sustainability issues, as reported by 31 leading global enterprises, as listed above.

Materiality Futures is available exclusively from Fronesys for £495 + VAT, where applicable. To get your own copy, contact Fronesys on info@fronesys.com or check out www.fronesys.com.

About Fronesys

Fronesys is a new sustainability advisory company which brings together a very experienced team of leaders in the areas of sustainability, ICT and corporate reporting.

We help companies understand their environmental, social and governance impact, and tie that impact to the more typical techniques and metrics companies use to make business decisions.

Each of Fronesys's partners are worldclass experts in their fields, with over 20 years of business experience each. The architects of Fronesys are specialists in their fields of sustainability, integrated reporting, business technology and ESG analysis.

Fronesys's clients benefit from a business-focused, data-driven approach to sustainability that allows them to integrate sustainability into their core business strategy. Our approach to materiality offers:

- a best practice benchmarking service
- advice on how to set up a materiality determination process
- tools for data capture and presentation
- advice on integrated reporting

Fronesys keeps this analysis up to date. If you have published a materiality matrix and would like it included please contact us.

Contact information

Internet: www.fronesys.com

Email: info@fronesys.com

Follow us on Twitter: [@Fronesys](https://twitter.com/Fronesys)

Press information:

Jyoti Banerjee, partner, Fronesys
jbanerjee@fronesys.com

Corporate enquiries:

Chris Tuppen, partner, corporate services
ctuppen@fronesys.com

Disclaimer

While Fronesys Ltd considers that the information, opinions and recommendations given in this work are sound and reasonable, users of the report must rely upon their own skill and judgement when interpreting or applying it.

Fronesys Ltd cannot, and does not, accept liability for losses suffered, whether direct or consequential, arising out of any reliance on the findings presented.

Copyright: Fronesys Ltd, 2011. All rights reserved.

Publication Date: October 2011
