MATERIALITY: Does it Matter?

Introduction

As ever more corporate social responsibility (CSR) issues compete for space in company reports, and vie for time and attention in the boardroom, companies need to be able to make decisions about which of these issues are really key – for their many stakeholders, for their commercial success and for internal management. Some issues are so important that they demand real recognition and effort by the company – but many other issues do not rise to this level. This threshold is referred to as materiality. Applying it in business is a matter of judgement – and the subject of engagement with stakeholders.

Overview

Materiality matters because it goes to the heart of what is meant by corporate accountability. Stakeholders, whether NGOs, investors or employees, have a right to expect a company to be accountable for their decisions and performance on issues:

- At the heart of their business
- That have a potentially large impact on people, the environment or company value
- That matter to them
- And, that the company can do something about, directly or indirectly

Determining what these issues actually are for individual companies is where materiality comes in. The concept is derived from the field of financial auditing, and has been defined 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.'[1] In other words, something is material if it has the potential to affect your perception of the company.

While, as a financial accounting term, the concept has been established for decades, it is far from straight forward. Even in the context of financial reporting, what is sufficient to change one observer's opinion may—and does—vary wildly from one to another. Financial analysts sometimes set a numerical threshold—perhaps 5% of a company's revenue—which determines financial materiality. Such a calculus would be impossible to duplicate for the array of sustainability issues a company faces. It is not difficult to see why 'carpet-bombing' has become so inevitable in sustainability reporting; demands for information have soared, with no tools to sort the wheat from the chaff.

Two key drivers have pushed materiality onto the CSR agenda:

- *Sustainability Reporting*: The dramatic expansion of issues companies report or are asked to report (including indicators proposed in the GRI[2] guidelines) has left many people wondering which issues are really the right ones to focus on, and why. AccountAbility states that reporting organisations should include in the public report "the information about its Sustainability Performance required by its Stakeholders for them to be able to make informed judgements, decisions and actions."

---

[1] *Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information*, Financial Accounting Standards Board (FASB).

[2] Global Reporting Initiative www.globalreporting.org

— *Socially Responsible* Investment: The aim of "value driven" [3] SRI is to identify sustainability issues that have the potential to affect business value. If a sustainability issue or risk has the potential to improve or threaten shareholder value, then it is worthy of investment consideration. In this instance, materiality refers both to sustainability issues and to financial materiality[4].

Implications

For business, an understanding and application of the concept of materiality helps them manage, and be seen to be managing, their significant impacts and issues better.

But what about the issues that don't make the materiality cut? Should companies just ignore those? In short, no. Things that rise to the level of 'materiality' in a company are those that require high-level, co-ordinated effort. Many other issues will still be addressed and managed by the company, and need to be communicated to stakeholders—but in focused, targeted ways—not in the annual report.

With a full understanding of materiality and how it works, stakeholders should become better equipped to raise the issues that matter most to them.

For NGOs and other stakeholders, the concept of materiality is key to:
— Understand how a business works and what makes it behave the way it does, and thereby how to engage better with companies
— Set expectations regarding how sustainability issues should be treated by companies and analysts

For investors and analysts, the importance of materiality is clear:
— Understanding how issues can affect a company and its value now and in the future
— Better, more sensitive recommendations and investment decisions

While the question of materiality is clearly critical, the concept is evolving massively and rapidly, making the development of a unifying definition or approach difficult. The key to gaining an understanding of materiality is engagement with stakeholders, both internal and external. Unfortunately, no single, simple tool yet exists to tell companies which issues to manage and communicate and how. The only way to understand how stakeholders perceive companies and make decisions is to listen to them.

Resources

1. Global Reporting Initiative position on Materiality: http://www.globalreporting.org/about/faq3.asp#Q11
2. Institute of Social and Ethical Accountability, *Redefining Materiality*: www.accountability.org.uk
3. Operating and Financial Review Working Group on Materiality: http://www.dti.gov.uk/cld/ofrwgcon.pdf

For more information:

Judy Kuszewski
+44 (0)20 7269 6908
kuszewski@sustainability.com

[3] As opposed to "ethically driven" investment, whose mandate it is to invest in companies screened on their ethical positions
[4] For further discussion, see SustainAbility and Mistra, *Values for Money: Reviewing the Quality of SRI Research*, 2004.