AccountAbility

Setting the Standard for Corporate Responsibility and Sustainable Development

Redefining Materiality II: Why it Matters, Who's Involved, and What It Means for Corporate Leaders and Boards

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"Materiality is like packing a backpack for a hike: you can only bring the supplies that are absolutely critical, otherwise the weight will slow you down and eventually bring you to your knees."

GARY NIEKERK
DIRECTOR, GLOBAL CITIZENSHIP
INTEL CORPORATION

Redefining Materiality II: Why it Matters, Who's Involved, and What It Means for Corporate Leaders and Boards

TABLE OF CONTENTS

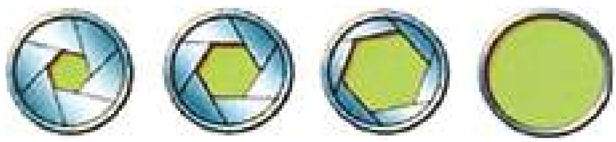
Executive Summary

How to respond to new definitions of materiality as applied to corporate performance and disclosure poses one of the biggest challenges facing boards and senior executives. Traditionally, materiality has been defined through the lens of financial reporting. Now, there's a powerful and growing movement to apply a more expansive definition that includes disclosure of the risks and opportunities posed by sustainability issues such as climate change, human rights, and board accountability. In addition to the substantive issues affecting environmental, social, and governance (ESG) domains, other features of this new materiality framework include: longer time horizons in which to gauge impacts on corporate performance, greater uncertainty concerning outcomes, and the views of a wider group of stakeholders who impact, and are impacted by, corporate behavior.

To remain competitive, firms need to develop new perspectives and processes on materiality that include the ability to:

- **Discern** which issues are most material to the company, its stakeholders, industry, and the wider operating environment. This is especially important because the materiality of sustainability issues continues to oscillate, with their impacts occurring over different time frames;
- **Develop** appropriate mechanisms and processes that enable continual learning and assessment of material priorities, and how performance improvements can occur;
- **Manage materiality,** based on these insights, in ways that anchor sustainability issues at the heart of a company's operating system;
- **Disclose** on a timely and transparent basis both progress and impacts of sustainability commitments within a wider context where they actually are felt.

Taken together, this means CEOs, senior managers, and boards need to gear up for a wider, more sophisticated, and—in some cases—mandatory framework for corporate disclosure. The emerging global conversation on



The corporate lens through which material issues are identified is expanding from strictly financial to other sustainability issues affecting human, social, natural, intellectual, and built environment capitals.

materiality—carried out by prominent players in the financial, regulatory, investor, ratings and information providers, and public interest communities—has widened the aperture on corporate reporting and valuation. No longer restricted to purely financial indicators or single issues such as climate risk or conflict minerals, materiality now includes a range of sustainability issues affecting "multiple capitals." These "multiple capitals" (sometimes called "vital capitals") build upon earlier efforts to value "intangibles," and refer to the "stock" and/or "flow" of financial, human, social, natural, built environment, and intellectual assets.[1] As a whole, they constitute a truer picture of the "value" of business enterprise, incorporating so-called "intangible" assets that now represent 80 percent of corporate valuation (Figure 1). They also call for better forms of measurement and management, to achieve peak performance. Multiple capitals theory is central to current work of the Sustainability Accounting Standards Board (SASB), the International Integrated Reporting Council (IIRC),[2] and the Global Initiative for Sustainability Ratings (GISR).

New materiality management calls for a different outlook on reporting and valuation—one that needs to be effectively managed and wired into a firm's operating system. Over time, the materiality lens will have implications for multiple operating areas. They will range from; risk and compliance to strategy setting, corporate policy and governance, management practices including stakeholder engagement, and even human resource management.

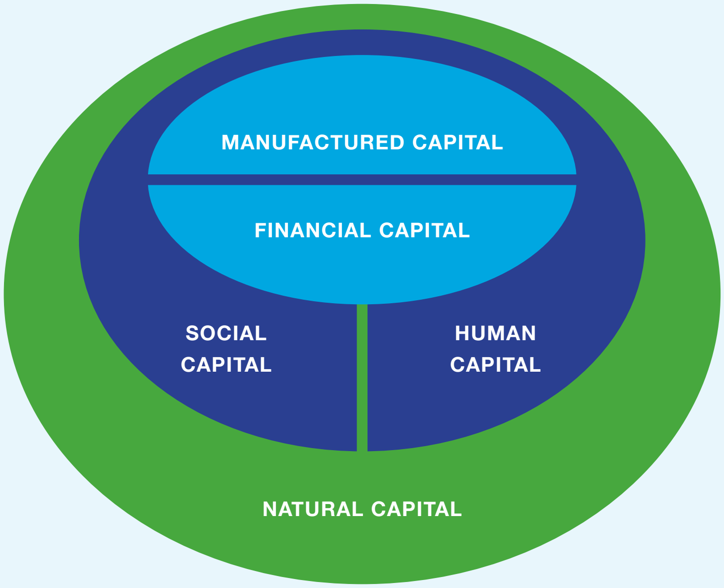
New materiality management also calls for a different leadership mindset on productivity, execution, and learning.[3] It means boards and senior executives will need to learn about and stay up-to-date on the landscape of materiality issues. Wiring new materiality management into the operating system means that many job descriptions will now include ESG issues in addition to strictly financial ones. This calls for new behaviors that meet new performance expectations, in ways that build upon what people already know about ESG materiality issues, and cross-pollinate with the expertise of others.

It means developing employee capacity to learn more about them on an iterative, ongoing basis, crossing knowledge and practice domains, learning to use interactive technology, and relying on multiple feedback loops to avoid becoming off-target or out-of-date.

New materiality management in a digital/Big Data era also calls for the application of rigor and discernment on priority ESG issues to avoid getting lost in the weeds. This means smart deployment of digital searches, Big Data platforms, reliable information sources, and direct, face-to-face encounters—both to solve and manage crucial problems ("What's going on in our supply chains?") and assure accurate disclosure to different stakeholders ("This is the actual impact on the environment of our material sustainability commitments.").

New materiality management in this vastly different environment thus calls for corporate leaders and boards to understand:

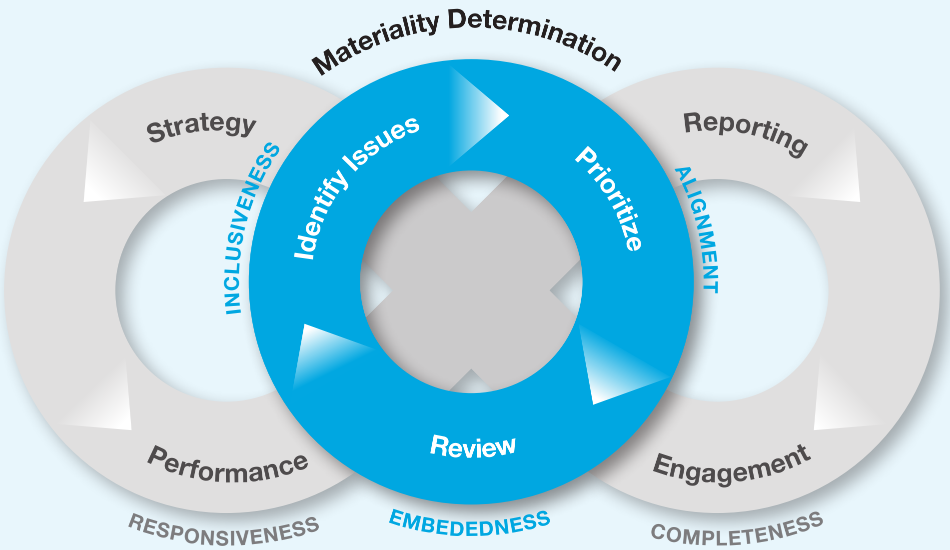
FIGURE 1. THE FIVE CAPITALS MODEL FOR SUSTAINABILITY PERFORMANCE



Multiple capitals theory is central to the work of major new global initiatives that currently are rewriting the rules of corporate disclosure and rankings, including the International Integrated Reporting Council (IIRC), the Global Initiative for Sustainability Ratings (GISR), and the Sustainability Accounting Standards Board (SASB).

Image source: Forum for the Future. http://www.forumforthefuture.org/project/five-capitals/overview

FIGURE 2. ACCOUNTABILITY'S PIONEERING MATERIALITY FRAMEWORK



The Materiality Framework demonstrates how business strategy, reporting, engagement, and performance can be aligned with environmental, social, and governance issues

Source: *The Materiality Report: Aligning Strategy, Performance, and Reporting,* AccountAbility, 2006. http://www.accountability.org/images/content/0/8/088/The%20Materiality%20Report.pdf

(a) **What's new and why it matters:** meaning managing materiality as a tool to identify and prioritize key issues that fall outside of traditional risk or financial management processes, but have long-term implications for the firm.

(b) **"Who's Who" among the array of actors** that are driving these new definitions and frameworks, and their long-term goals, objectives, and time frames.

(c) **How to take a disciplined approach to determining and prioritizing materiality**. AccountAbility's pioneering framework is a good example, providing a structured roadmap for determining and embedding material issues in an integrated way. It has informed the work of current materiality reforms (See Appendix for a fuller description). With or without future mandatory sustainability reporting, this approach enables companies to efficiently target their resources on those matters deemed material to its sector and stakeholders, rather than waste time on immaterial issues that carry little risk or strategic value other than possible reputational benefits (Figure 2).

(d) **What lies ahead that will shape the future of "materiality" discussions, and achieve enhanced competitive and sustainable performance.** This includes issues such as sustainability context-based approaches to materiality. Context-based approaches move the needle on strategy and goal-setting from company-specific ESG goals and metrics ("intentions") to those tied to wider ESG thresholds that sustain and improve the environmental and social context in which firms operate ("impact").

I. What's New and Why It Matters

SHAREHOLDERS' RISING INFLUENCE

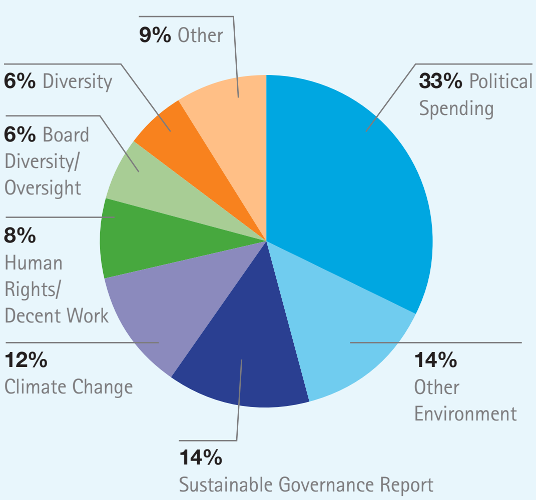
You need look no further than this past proxy season to see how "nonfinancial" social, environmental, and governance issues have come to dominate the agenda. That's because investors recognize the financial implications, risks, and opportunities these issues pose—in short, their materiality. At the top of the list: political contributions and lobbying, climate and the environment, sustainability oversight and reporting, human rights, board diversity, workplace oversight, and a range of social issues (such as animal testing, net neutrality, and public health) (Figure 3).

According to *Proxy Monitor,* a project of The Manhattan Institute's Center for Legal Policy, this year sustainability proposals constituted 42 percent of shareholder resolutions filed with Fortune 250 companies—up from 37 percent across the entire 2006 to 2013 time period (Figure 4).[4]

This is not a passing fad. Nor are ESG concerns restricted to companies alone. "Shareholders want greater accountability on sustainability issues across the supply chain," said Heidi Welsh, founder and executive director of Sustainable Investments Institute (Si2), a prominent Washington, D.C.-based nonprofit that tracks and analyzes

FIGURE 3. SHAREHOLDER VIEWS ON MATERIAL SUSTAINABILITY ISSUES

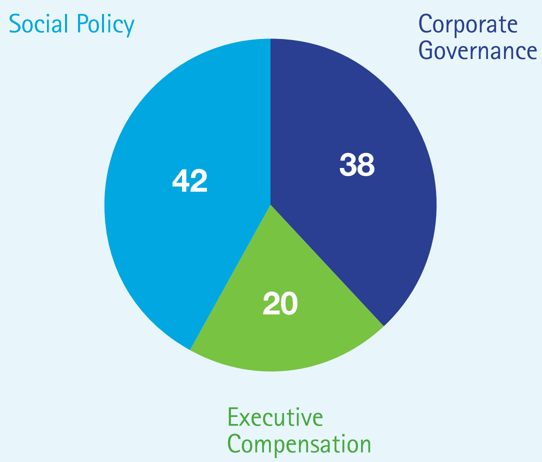
2013 Social and Environmental Proposals Filed



Source: Proxy Preview 2013, co-produced by Sustainable Investments Institute (Si2), As You Sow, and Proxy Impact, at http://www.proxypreview.org/

FIGURE 4. SHAREHOLDER CONCERNS AT BIG CAP COMPANIES

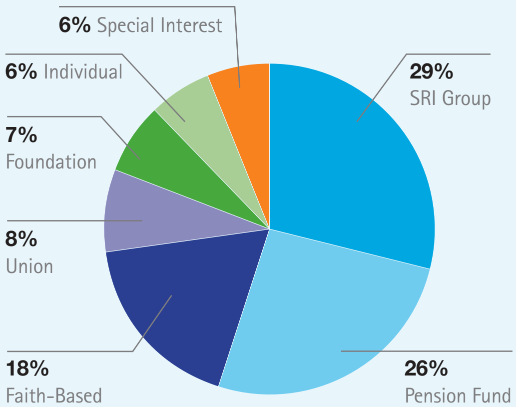
Percentage of Shareholder Proposals by Type, Fortune 250, 2013*



Source: Proxy Monitor, The Manhattan Institute, 2013 at http://www.proxymonitor.org/Forms/2013Finding4.aspx

FIGURE 5. 2013 PROXY SEASON MAJOR PLAYERS

2013 Primary Filers



Source: Proxy Preview 2013, co-produced by Sustainable Investments Institute (Si2), As You Sow, and Proxy Impact, at http://www.proxypreview.org/

social and environmental proxy issues. "The dominant theme is, *disclose,"* she said.[5] Leading the proxy pack: corporate political spending and climate risk. A comprehensive analysis of the 2013 resolutions, along with issue commentary from prominent experts, appears in the *Proxy Preview 2013* report, co-produced by Si2 along with As You Sow and Proxy Impact.[6]

"Political spending proposals are the connective tissue of proxy season, since they question how companies influence laws and regulations on all the other topics," Welsh said. "Resolutions on political spending show no sign of letting up even though the Presidential election is behind us."[7] About 120 political spending proposals have been filed in each of the last two years—twice the level of 2010.

No longer restricted to "gadflies," institutional investors now dominate the "new materiality" landscape. They're filing resolutions, often in conjunction with others. Major players include socially-responsible investment funds, pension funds, faith-based investors, unions, foundations, special interest groups, and individuals (Figure 5).

These investors, along with other advocacy groups and corporate governance experts, are calling upon public companies to understand their shareholders, and engage with them. That's why there's a greater emphasis on company/shareholder engagement, now including the board of directors.

MORE STAKEHOLDERS NOW ENGAGED

In addition to shareholders, a wide array of stakeholders are now demanding corporate disclosure of information on a variety of ESG issues apart from financial reporting. These stakeholders include:

- Customers and consumers, who are now in the driver's seat thanks to the proliferation of mobile devices and other digital technologies.

MARKETPLACE CONFUSION AND DISCLOSURE OVERLOAD

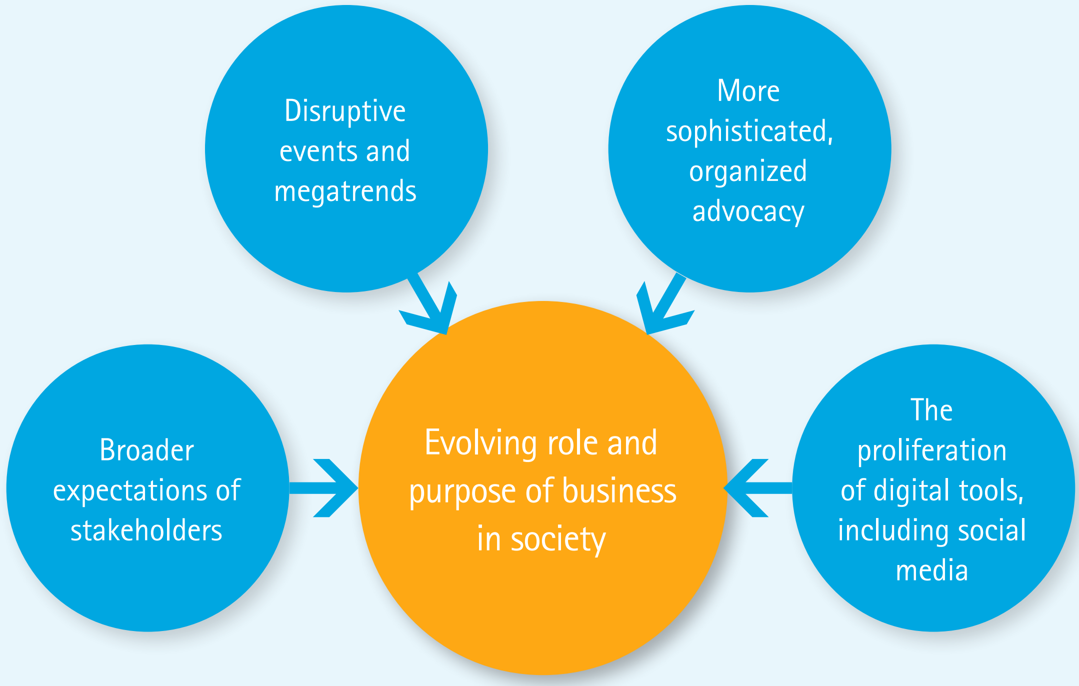
More than 500 sustainability issues are currently tracked by dozens of entities, relying on 2,000 indicators. This leads to confusion in the market-place about quality and credibility. A single large company may receive more than two dozen surveys annually, all of which seek information – often duplicative – tailored to meet the data needs of various ratings.

Companies often question whether the requested data is material to their business and express skepticism that the outcomes will actually drive performance improvement. A company may be scored a sustainability leader by some ratings and a laggard by others, creating difficulties for users to understand the causes of such variability.

- Regulators, who increasingly recognize the materiality of issues involving climate risk, human rights, and bribery and corruption.
- Stock exchanges, which are developing new listing requirements with ESG disclosure and/or "integrated reporting" (merging financial and sustainability reporting into one report) as a ticket to admission.
- Information/data providers, such as Bloomberg, which has ESG information available on its terminals. Other data providers and businesses—such as Goldman Sachs, Deutsche Bank, UBS, Merrill Lynch, and Credit Suisse—have established functions to analyze ESG data from Bloomberg and its ESG competitors. And Moody's has begun to think about how ESG considerations can be factored into their ratings.
- Special interest/advocacy/NGO groups, which have honed their tactics and rely on social media and other technologies to organize and target poor performers.
- Prominent new global players and new sustainability disclosure and ratings frameworks. In addition to the Global Reporting Initiative (GRI), these new players include the International Integrated Reporting Council (IIRC), the Sustainability Accounting Standards Board (SASB); and the Global Initiative on Sustainability Ratings (GISR).

One reason for the rise of these players and disclosure and ratings frameworks: the proliferation of individual sustainability disclosure requests to corporations, along with multiple ratings-and-rankings schemes (at last count, there's an estimated 500

FIGURE 6. CONVERGING DEVELOPMENTS AFFECTING BUSINESS AND SOCIETY



issues and 2,000 indicators in the marketplace). This has contributed to a form of "disclosure overload" and confusion in the marketplace as firms wonder if there are competing or dueling standards. Confusion can lead to inconsistencies in the quality and comparability of reports, or ratings-and-rankings performance systems. These standards have emerged to create clarity, standardize definitions and disclosure frameworks, with a focus on impacts.

- An emerging emphasis on context-based sustainability. As continued pressure to integrate ESG factors into business practice and disclosure matures, there is an equivalent push for greater focus and disclosure on their definition and impact. This means tying them to specific performance outcomes within the *context* of sustainability realities. The aim: to provide key stakeholders, including investors, with insight into the continuum of ESG factors and how they will shape institutional performance. Already, there are signs of a context-based approach springing up throughout the world. "Ben & Jerry's, BT, Autodesk, EMC, Mars, Ford, and Cabot Creamery Cooperative have all integrated thresholds into their carbon-management strategies, aligning their emissions reduction targets with science-based climate stabilization models," according to Bill Baue, Mark McElroy, and Cary Krosinksy, highly-regarded sustainability advocates and co-authors of a recent article on sustainability context.[8]

CONVERGING DEVELOPMENTS

Shareholder activism on ESG matters is one part of a wider convergence of trends affecting the role and purpose of business in society. All of which have implications for corporate performance, and how firms gain competitive advantage within a wider, more complex ecosystem of risk and opportunity. They include:

- Stakeholders—especially investors, consumers, regulators, financial information providers, and younger people—have broader expectations of business. This is manifest in the embrace of sustainability standards in emerging BRIC markets.
- Disruptive events and megatrends, especially catastrophic weather events that capsize assets, scandals that cause mistrust, the kind of governance breakdowns that triggered the financial crisis, or changes in public opinion about a company's reputation and worth.
- More sophisticated organized advocacy arising from the investor community, business coalitions, and nonprofit advocacy groups. Noted CSR experts Jane Nelson and David Grayson describe the powerful impact of these in their new book, *Corporate Responsibility Coalitions: The Past, Present, and Future of Alliances for Sustainable Capitalism.*[9]
- The proliferation of digital tools, including social media and other forms of interactive technology, and XBRL (e.g., electronic tagging and information organization now required by the SEC for all filings), that collapse boundaries and shift power away from central sources to investors and other stakeholders. These electronic tools enable greater public access and data comparability, thus helping investors and other stakeholders make better decisions.

Taken together, these developments affect the judgment of investors, financial analysts, regulators, corporate leaders and other stakeholders about how business value is created or destroyed. They build upon a long history of sustainability standards: concerns with environmental health and safety in the 1970s; the emergence of corporate governance concerns in the 1980s, along with human rights and responsible international behavior (toward South Africa, in particular); and the emergence of a robust environmental movement in the 1990s. In the 2010s, a broader set of issues emerged involving social and governance issues, as well as climate-related risks.

Some parts of the world are further along in tying materiality to sustainability than others—particularly Europe, Australia, and parts of Asia, Latin America, and Africa—but the overall momentum will continue. There's no turning back from integrating of "nonfinancial" outcomes into business strategy, performance, and engagement because investors and stakeholders are demanding it *and* they have financial implications on the balance sheet.

II. Rapid Momentum to Expand Definition of "Materiality"

Public concerns about materiality originated with the legislation creating the Securities and Exchange Commission (SEC) in 1934. It continued with subsequent interpretations of its mandate to require disclosure of information for the protection of investors and the public interest. The SEC has continued to rule that qualitative, as well as quantitative, data can be considered material for disclosure purposes, even though financial disclosure has dominated.

Core to the definition of materiality is the notion that corporate information is material if its omission or misstatement would influence decisions made by general users of the information.

Definitions of materiality and related guidance for financial reporting have evolved over the years, as new interpretations of materiality principles were adopted by standard setters, regulators, and international organizations. Their interest in materiality is much bigger than the environment because other non-financial areas have financial implications across the sustainability spectrum. That's what AccountAbility set out to do in 1998 with the AA1000 Series of Standards, and what the Global Reporting Initiative (GRI) continued with issuance and periodic update of its Sustainability Reporting Guidelines. (The GRI's most recent reporting guidelines, called "G4," were released in late May.)

A key difference embodied by GRI and AccountAbility is that greater emphasis is placed on broader "users" of information, beyond investors or shareholders, who are directly engaged in the process of definition and standards setting.

GLOBAL CONVERSATIONS

More recently, several simultaneous global conversations about expanding and codifying materiality are underway. They push the boundary even further, and are evolving in different ways, depending on scale, scope, and geography. What they hold in common is a belief in new frameworks, timeframes, and metrics. Their focus: climate risk, political contributions, human rights, supply chain integrity, bribery and corruption, diversity, product quality and safety, and corporate governance.

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.

According to noted authors Robert G. Eccles, Michael P. Krzus, Jean Rogers, and George Serafeim, most definitions and interpretations of materiality are "principles-based" and fairly general.[10] (AccountAbility's AA1000 Standards are principles-based.) In the U.S., materiality is rules-based. General guidance for both approaches occur within clearly defined accounting standards—a Generally Accepted Accounting Principles (GAAP) in the U.S., the International Financial Reporting Standards (IFRS) everywhere else—promulgated by groups such as the Financial Accounting Standards Board (FASB) in the U.S. and the International Accounting Standards Board (IASB) throughout the rest of the world. The authors Eccles et al. argue for a way of defining materiality that accommodates both rules-based and principles-based approaches.

At a corporate level, the challenge is not only to stay abreast of these conversations, but also to apply a methodology that's robust enough to define those issues in anticipation of new disclosure requirements, and embed them into business models and long-term strategy.

Key questions become: How will you know which are the most important environmental, social, and governance issues that affect competitive performance, including brand, reputation, and customer base? Who are you going to ask to answer this question, and how will you prioritize the answers? Once you've done that, how will you weave these sustainability risks and opportunities into your business strategy?

Early attempts to do this often involved creation of a "materiality matrix," which featured issues considered important to both companies (on one axis) and stakeholders (on the other axis). While useful as a preliminary map, the effectiveness of materiality matrices is somewhat limited. That's because they often don't show the priorities of different groups, or the industrial benchmarks used by peers and investors to compare performance, or characteristics such as "innovation" that represent resilience and adaptability to changing times. They also don't show key sustainability performance indicators within an industry, or provide for future disruptive events or changes in stakeholder priorities that may change the mix.

Traditional assessments of financial materiality take an overly myopic view of what drives business performance. Just as AccountAbility did in 2006 (see Appendix), a new approach to materiality needs to focus on what is important to the business. But it needs to do this with a wider focus, in order to capture:

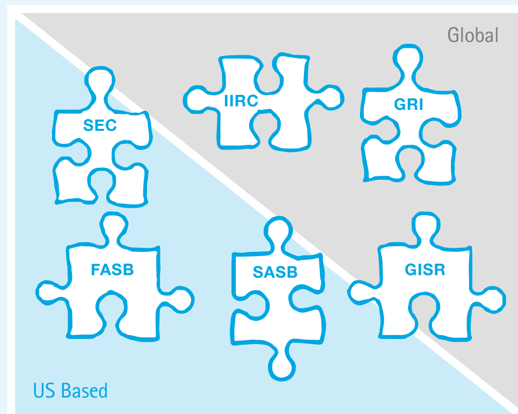
- A longer-term view of the issues that could affect the success of its strategy.
- A wider view of the people whose actions influence performance, and who therefore need sound information to guide their judgments.
- A deeper view of the information necessary for sound decision making, including where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

III. Leading Actors Driving Change

To meet these challenges, current work on materiality seeks to widen its scope, anchor it in practice and evidence, and recognize the particular significance of conditions, circumstances, and context. Leading actors driving this change rely on a collaborative, multi-stakeholder approach; they're committed to transparency; they're using an iterative or "formative" approach that makes adjustments as the work unfolds; and they're relying on digital tools and data-based evidence to foster better decision making and stakeholder engagement (Figure 7).

Most are aimed at reporting, but have implications for short, medium, and long-term strategy development; stakeholder engagement; and performance management. Leading actors driving this change represent different schools of thought about sustainable performance, and constitute the building blocks of an emergent global sustainability architecture. These building blocks include:

FIGURE 7. LEADING ACTORS ON SUSTAINABILITY MATERIALITY



Source: Sustainability Accounting Standards Board (SASB).

Upgraded Sustainability Reporting Framework (GRI G4)

Established in 1997, the Global Reporting Initiative (GRI) is the "gold standard" in corporate sustainability reporting. It is widely and correctly viewed as ushering in the sustainability reporting field as we know it. In May 2013, GRI released its fourth generation of Sustainability Reporting Guidelines, "G4", which fundamentally places materiality at the core of its reporting process. G4 requires reporting organizations to list all of their material issues, the process used in making that determination, and the relevant parts of the organization and/or value-chain where those issues apply.

To make the transition from the previous GRI generation, G3.1, to G4 as smooth as possible, GRI is introducing the G4 Guidelines and content through a series of international launch events over the next year. The first of these were held this past June in Canada, the U.S., Brazil, and New Zealand.

GRI also is also partnering with the International Integrated Reporting Council (IIRC) to advance integrated reporting globally.

Integrated Reporting (IIRC)

On 16 April 2013, the International Integrated Reporting Council (IIRC) released its draft *Consultation Draft on the Integrated Reporting Framework;* the comment period ran through July 15, 2013, with Version 1.0 of the final Integrated Reporting Framework slated for release in December 2013. As part of the run-up to the Consultation Draft, three background papers—on materiality, business model, and "the capitals"—were prepared by an IIRC Technical Collaboration Group, with contributions from American Institute of Certified Public Accountants (AICPA), Chartered Institute of Management Accountants (CIMA), International Federation of Accountants (IFAC), and PricewaterhouseCoopers (PwC), Association of Chartered Certified Accountants (ACCA) and Netherlands Institute of Chartered Accountants (NICA).[11]

Industry-Based Sustainability Standards (SASB)

In the U.S., the Sustainability Accounting Standards Board (SASB) released an Exposure Draft of its *Conceptual Framework,* the foundational document that guides SASB's

FIGURE 8. GLIMPSE OF SASB MATERIALITY MAP™ FOR HEALTH CARE

SASB Materiality Map™

SASB's Materiality Map lays out the relative priority of sustainability issues on an industry by industry basis. Click here to learn how it is created and here to learn about the shading and scoring system underlying the Map.

Industry Issues
• Higher Materiality
• Lower Materiality

Click on any cell to see a breakdown of the Materiality Score and additional comments on the issue.

ISSUES	Health Care					
	Biotechnology	Pharmaceuticals	Medical Equipment & Supplies	Health Care Delivery	Health Care Distribution	Managed Care
Climate Change Risk	3.75	3.25	1.25	0.75	0.75	1.00
Environmental accidents and remediation	0.75	1.25	1.50	1.00	1.00	0.75
Water use and management	1.00	1.25	1.25	1.00	1.00	1.00
Energy management	2.25	2.50	2.25	3.75	1.00	1.75
Fuel management and transportation	0.50	0.75	0.75	0.50	2.25	0.50
GHG emissions and air pollution	1.00	1.00	1.75	1.00	1.00	1.00
Waste management and effluents	3.00	3.00	2.50	3.25	1.25	0.75
Biodiversity impacts	1.00	0.75	1.00	1.25	1.00	1.00
Communications and engagement	1.00	1.00	0.75	1.00	0.50	1.25
Community development	0.50	0.75	0.75	1.75	1.25	0.50
Impact from facilities	0.50	1.00	1.00	4.00	1.25	1.00
Customer satisfaction	0.75	0.75	1.00	2.25	1.00	3.00
Customer health and safety	5.00	5.00	3.00	3.00	1.50	2.50
Disclosure and labeling	3.00	3.00	2.50	0.75	2.25	0.75
Marketing and ethical advertising	2.50	2.50	2.50	1.75	2.00	1.75
Access to services	4.25	4.50	2.50	3.00	3.00	3.00

Source: Sustainability Accounting Standards Board (SASB) at http://www.sasb.org/materiality/sasb-materiality-map/

standards development process and explains the concepts and definitions relevant to SASB's work. The end of the 45-day comment period was July 27, 2013. SASB is engaged in the development and dissemination of industry-specific standards for disclosure and accounting of material sustainability issues; as such, SASB represents the latest iteration in the evolution of corporate reporting.

SASB is establishing an understanding of material sustainability issues facing industries and creating Sustainability Accounting Standards suitable for disclosure in standard filings of publicly-held companies to the U.S. Securities and Exchange Commission (SEC), such as the Form 10-K and 20-F. It's working to establish industry-based materiality standards for each of the 88 industries in the Sustainable Industry Classification System™ (SICS™) most relevant to all 12,500 publicly traded companies on U.S. stock exchanges. SASB is doing this through a multiparty collaborative process—a series of "Industry Working Groups"—that also will help investors and companies determine which sustainability issues are most applicable. SASB has created a SICS™ Look-up Tool that is powered by the Bloomberg Industry Classification System, which considers revenue and other overriding factors to classify companies under one primary industry.

The outcome: An interactive SASB Materiality Map™ for each of the sectors, based on a "three-lens" process in which SASB gathers "Evidence of Interest," "Evidence of Financial Impact," and, in some cases, "Forward-Looking Adjustment" to highlight emerging interest in an issue that has yet to ripen. Figure 8 provides a glimpse into how material issues are defined and prioritized within the Health Care Sector.

SASB standards will each consist of "Performance Indicators" and "Management Disclosures", grouped into "Impacts" and "Innovation Opportunities." They will be concise, material, benchmarkable, and suitable for disclosure in the Form 10-K, 20-F and other required SEC filings. To that end, throughout this process SASB is communicating with the SEC, with an eye toward eventual adoption of sustainability key performance indicators (SKPIs). Investors will be able to assess key risks and opportunities that materially contribute to an organization's valuation (or risk exposure) and its ability to create long term value. Already SASB has developed draft standards for the health care, financial services, and technology and communication sectors; work begins on the Non-Renewable Resources sector in August, with other sectors lined up for each quarter through Q1 in 2015.

Worldwide Unified Sustainability Rating Standard (GISR)

The Global Initiative for Sustainability Ratings, co-launched in June 2011 by Tellus Institute and Ceres, will make it a bit easier to determine "corporate sustainability excellence," and give investors a better sense of how their holdings compare with peer-based benchmarks. "The vision is to see sustainability ratings as important as financial ratings," said GISR and GRI co-founder Allen White.

GISR will design and steward a global sustainability (ESG) ratings standard to expand and accelerate the contribution of business and other organizations worldwide to sustainable development. GISR will not rate companies. Instead, it will accredit other sustainability ratings, rankings or indices to apply its standard for measuring excellence in sustainability performance.

Currently, approximately 100 sustainability raters administer questionnaires to thousands of companies worldwide, comprising a mix of investor and consumer-facing instruments ranging from issue-specific (e.g., climate change) to multi-issue (integrated environmental, social, and corporate governance factors) ratings, rankings, and indices. GISR seeks to reconcile the perspectives of companies, investors, and raters to drive capital markets toward sustainability outcomes. "We're agnostic about how many ratings schemes are out there, but we're not agnostic about excellence," White said. "Already we've had a discussion with Moody's about how to integrate ESG issues into their judgment of companies."

Public Policy Initiatives

In mid-April the European Commission (EC) set a milestone, opening the door for increased disclosure by large European companies on non-financial matters. On April 16, 2013, the EC announced proposals to amend the Fourth and Seventh Accounting Directives to enhancing the transparency of certain large companies on social and environmental matters.

The Commission's aim is to improve business transparency and performance on social and environmental issues and the measures are likely to impact around 18,000 businesses across the EU. On February 6, 2013, the European Parliament adopted two resolutions ("Corporate Social Responsibility: accountable, transparent and responsible business behaviour and sustainable growth" and "Corporate Social Responsibility: promoting society's interests and a route to sustainable and inclusive recovery"), acknowledging the importance of company transparency in these fields.

Stock Exchanges/Listing Standards

Last June, on the eve of the Rio+20 Summit, a core group of five major exchanges from the U.S., Brazil, South Africa, Turkey, and Egypt announced plans to promote long-term sustainable investing and disclosure in their markets. In mid-February 2013, Pakistan's Securities and Exchange Commission approved voluntary guidelines for corporate social responsibility

THE SUSTAINABLE STOCK EXCHANGES INITIATIVE IS A U.N.-BASED PROJECT PROMOTING A PUBLIC COMMITMENT TO SUSTAINABILITY IN GLOBAL MARKETS.

The Sustainable Stock Exchanges Working Group, a project of the Investor Network on Climate Risk (INCR) and Ceres, offers investors engagement opportunities with stock exchanges on environmental, social and governance (ESG) issues, with the goal of improving exchanges' guidance for listed companies through a listing standard on sustainability reporting.

disclosure. In 2010, the U.S. Securities and Exchange Commission mandated disclosure of climate-related risk. In 2012, it required disclosure related to "conflict minerals." On 23 July 2013, the SEC's conflict minerals rules were upheld by a U.S. federal court judge, who rejected arguments made by the U.S. Chamber of Commerce, the Business Roundtable, and the National Association of Manufacturers that they were too costly and violated companies' First Amendment free speech rights. In April of this year, the Investor Network on Climate Risk released a Consultation Paper on a proposed uniform standard for global stock exchanges that would require sustainability disclosure as a condition of listing. Meanwhile, the U.N.'s Principles for Responsible Investment (PRI), Global Compact, Conference on Trade and Development, and UN Environmental Programme Finance Initiative (UNEP FI) have formed the Sustainable Stock Exchange Initiative. The Sustainable Stock Exchange Initiative is exploring how exchanges can work together with investors, regulators, and companies to enhance corporate transparency, and ultimately performance, on ESG issues, while encouraging responsible long-term approaches to investment.

IV. Implications and Actions for CEOs, Boards, and Senior Executives

We're in the midst of widespread adoption of new frameworks affecting capital markets and corporate governance and management. New definitions and management of materiality represent a natural extension of movements to promote greater corporate responsibility, accountability, and transparency that have been active for a very long time. It's also a sign of the maturation and harmonization of disparate global efforts. We're now on the threshold of a new era in business activity that offers opportunities to reduce costs, improve performance, and live up to sustainability commitments. Beyond rhetoric, the reality is that stakeholders—a wide range of them, from investors to regulators, ratings agents, and regular people—are looking to see if firms are doing what they say, in ways that fulfill their expectations, not undermine them. These have profound implications for the duties and obligations of CEOs, boards, and senior executives—and, by extension, the stakeholders themselves. (This part of the equation often is overlooked.)

New definitions and management of materiality will affect virtually every aspect of corporate operations, from the board room through the supply chain and extending through the product life cycle. At a minimum, CEOs, boards, and senior executives will need to familiarize themselves with recent developments and begin to sort through how they will link material sustainability issues to their financial reporting, stakeholder engagement and, increasingly, assess the impact of their sustainability performance (externalities) on a wider context. That's a process of discernment and development, as mentioned earlier, that involves a wide variety of corporate personnel and stakeholders, across disciplines and departments.

More than that, CEOs, boards, and senior executives will need to understand the strategic importance of material sustainability issues, and make sure they are effectively managed. "Effective management" calls for a suite of new knowledge and skills, building on what already is there, and is necessary to reporting, stakeholder engagement, and determining sustainability impacts. This involves new partnerships with reputable policy institutes and analysts, so that the substantive issues of material importance—on

KEY IMPLICATIONS

- *Understand developments in the definition of non-financial materiality issues, their strategic importance and how they impact your company's performance.*
- *Ensure that material sustainability issues are effectively managed and develop new partnerships.*
- *Manage for the future by making dynamic, emergent learning a priority.``*

climate, human rights, corporate governance, economic and political stability, employee health and safety, supply chain performance, and so on—are comprehended and continually updated.

Finally, CEOs, boards, and senior executives will need to adopt a new framework for excellence, one that puts dynamic, emergent learning at the center, rather than more static "knowledge transfer"—because new materiality management is about managing for the future, not just reiterating what's worked in the past. It's about foresight, not hindsight. Approaching new materiality management this way creates a climate conducive to innovation and experimentation—and failure, because after all, who can fully predict what the future holds?—that, in turn, reignites an entrepreneurial spirit so vital to competitive advantage and continued business success. The bonus: it's also vital to wider community well-being and prosperity, particularly for future generations.

Leading companies will seize the opportunity posed by new materiality management, and put processes into place to manage both financial and sustainability issues.

Other groups in the corporate reporting ecosystem, of course, are also affected by these new definitions and applications of material sustainability priorities. Accountants and auditors, management consultants, securities lawyers, investors, and advocacy groups will need to make adjustments in their goals and tactics. This too, will require retooling and continuing education and development.

V. Final Word

AccountAbility remains at the forefront of new materiality management, and continues to advocate for wider, broader, and deeper sustainability disclosure and an integrated approach to corporate reporting. It will continue its involvement with several of these global initiatives, including the International Integrated Reporting Council, the Global Reporting Initiative, and the Sustainability Accounting Standards Board. We expect the velocity of these developments will accelerate in the years ahead and not stall.

The key question facing corporate (and investor) leadership is: how ready are you to incorporate these responsibilities for externalities and transform them into assets?

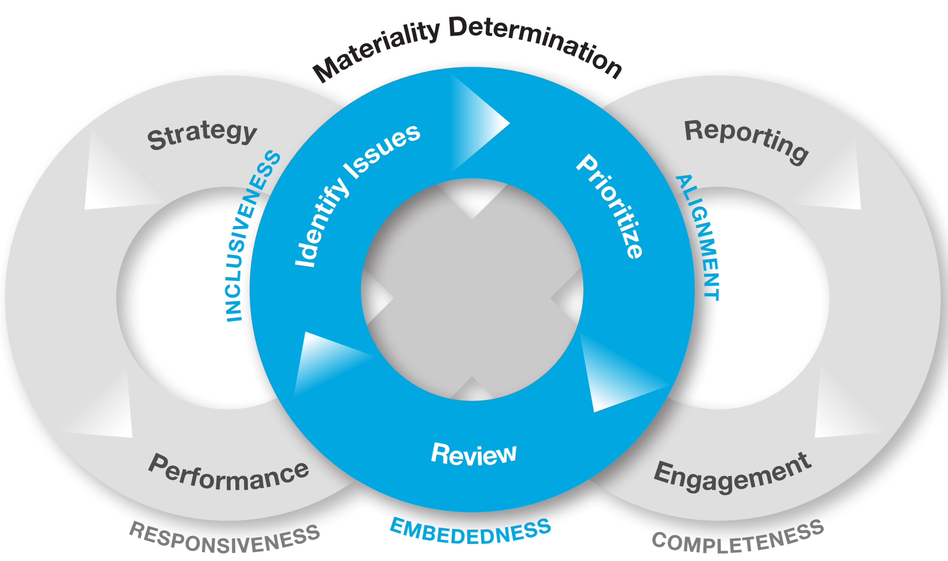
Appendix: AccountAbility's Materiality Framework

In *The Materiality Report*[1], AccountAbility designed a Materiality Framework that can be used by businesses to help align their strategy to emerging social and environmental constraints and opportunities. This framework enables business leaders and managers to better understand how emerging sustainable development issues could be integrated into their organizational DNA, thus driving business strategy and performance.

In this framework, the question of 'what is material' is framed to include the information needs of both management/investors and other stakeholders who take decisions that can affect a business performance in the long-term.

AccountAbility's Materiality Framework (illustrated in the diagram below) is based on a cycle of three broad stages: identify issues, prioritize, and review. These three stages are depicted in the center blue ring of the diagram.

In practice the three key steps presented as a cycle often overlap with each other or double back in iterative loops. In any case, this framework can be an extremely helpful tool for companies to assess gaps in their definition, prioritization, and/or implementation of material issues. The following are the main elements to take into account in order to do this:



This Materiality Framework demonstrates how business strategy, reporting, engagement, and performance can be aligned with environmental, social, and governance issues.

[1] 'The Materiality Report: Aligning Strategy, Performance and Reporting.' AccountAbility. (November 2006).

ISSUE IDENTIFICATION

In order 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, companies need to:

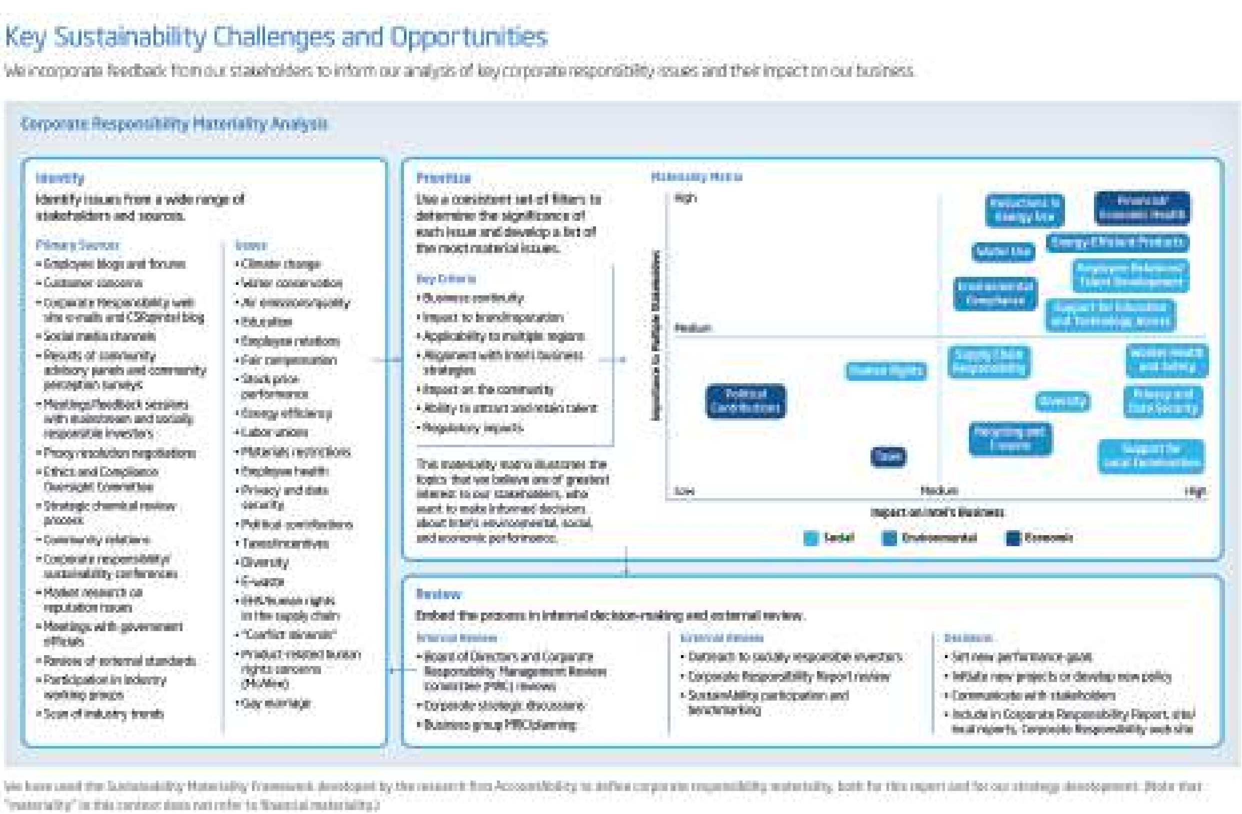
- Identify a long list of issues relevant to direct short-term financial performance, ability to deliver on strategy and policies, best practice norms exhibited by peers, stakeholder behavior, and concerns and societal norms.
- Enable all significant stakeholders' viewpoints to feed into the analysis.
- Draw on internal and external sources of information.

PRIORITIZATION

In order to sift out the issues according to how significant they are and therefore identify the information flows needed to enable sound decision making and action, companies need to:

- 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. The external criteria should be weighted to reflect most strongly those stakeholders that can influence the business.
- Decide on thresholds on the internal and external axis to divide the map into bands of materiality. This may be a simple division into material/not material categories or it could be more sophisticated, indicating a scale of levels of materiality.

INTEL'S APPROACH TO DEFINING MATERIALITY



Source: Intel 2012 Corporate Responsibility Report. http://www.intel.com/content/www/us/en/corporate-responsibility/corporate-responsibility-report-overview.html

- 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.

REVIEW

In order 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 its implications, the whole process should be reviewed by internal and external expert advisory panels and agreed upon at board-level.

Intel is an example of a company that applies AccountAbility's methodology. Page 19 contains an excerpt of Intel's 2012 Corporate Responsibility report that shows how the company applies the three steps of Issue Identification, Prioritization, and Review.

In addition to Intel, other companies specify that their materiality determination processes are based on AccountAbility's framework or test:

- The Swedish company Electrolux explains in its annual report[II] how the company uses a materiality process based on Accountability's framework to identify priorities and align strategy and reporting with emerging stakeholder expectations.
- Jones Lang LaSalle[III] has indicated that the company's process to define material impacts is based on external materiality standards such as Accountability's materiality test.
- The Danish pharmaceutical company Novo Nordisk has applied AccountAbility's Five-Part Materiality Test to determine material issues. An example of Novo Nordisk's material non-financial performance within the Five-Part Materiality Test can be found in their annual report.[IV]

Moreover, other companies apply methodologies for materiality determination that are based on or inspired by the three main stages—Identification, Prioritization, and Review—of AccountAbility's framework. Some examples are:

- TD Bank: The company's materiality determination methodology consists of the same three phases, identified as Identification, Prioritization, and Validation.
- Sprint: Its two-stage process of issue identification and issue prioritization provides a result that is then reviewed, discussed, and altered through ongoing conversations with key business and function leaders.
- Campbell's: The company's materiality analysis also includes the phases of Identification, Prioritization, and Review, adding an extra phase called Filter between Identification and Prioritization.

ENSURE THAT THE MATERIALITY DETERMINATION METHODOLOGY IS EFFECTIVELY WIRED INTO THE COMPANY TO MAXIMIZE ALIGNMENT, EFFICIENCY, AND IMPACT

For the whole materiality framework to be complete, the materiality determination methodology needs to be embedded within the company's ongoing processes of strategy development, performance management, reporting, and stakeholder engagement. This comprehensive approach is illustrated by the two outer gray rings in the diagram on page 18.

The endpoint of the materiality determination process 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 also where strategy needs to be responsive to changing social and environmental circumstances. It also provides a useful framework for stakeholder engagement efforts.

Material issues can be embedded into the company's processes in at least four ways that ensure efficiency and impact:

- Strategy: 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.
- Performance: To promote internal understanding of the link between ESG issues and business performance. The materiality determination provides a link between issue experts and strategic and operational managers.
- Stakeholder engagement: To provide a framework to design stakeholder engagement strategies and a powerful tool to help identify opportunities for dialogue and collaboration.
- Reporting: To determine the scope of corporate reports and other communications so that they are more strategically aligned and useful to external stakeholders.

II Electrolux Annual Report 2012. http://annualreports.electrolux.com/2012/en/sustainability/valuechain/materialityprocess/materiality-process.html

III Jones Lang LaSalle and LaSalle Investment Management 2010 CSR Report (available here), page 12.

IV Novo Nordisk Annual Report 2008. http://annualreport2008.novonordisk.com/how-we-are-accountable/materiality.asp

Use to inform future strategy

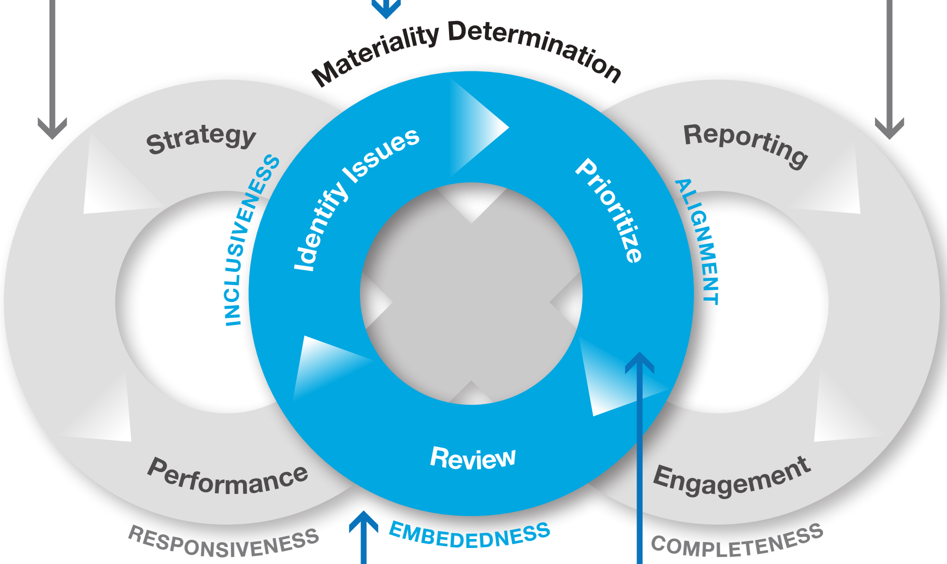
- Constraints
- Opportunities

Stage 1: Identify issues from a wide range of stakeholders 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, government, etc.

Use as the basis for publishing information on

- Policies
- Actions
- Performance

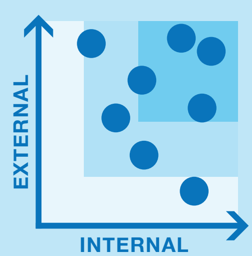


Stage 3: Embed process in internal decision making and external review

Ideally process should be subject to:

- Review by internal and external advisory panels
- Sign-off at board level
- Independent assurance as part of overall reporting process.

Stage 2: Use a consistent set of filters to determine level of significance for each issue



Endnotes

[1] See especially the work of the award-winning Baruch Lev, the Philip Bardes Professor of Accounting and Finance at New York University Stern School of Business. Baruch Lev, *Intangibles: Management, Measurement, and Reporting, and Financial Statement Analysis: A New Approach* (Washington, D.C.: Brookings Institute Press, 2001). An ebook can be viewed freely at http://books.google.com/books/about/Intangibles.html?hl=es&id=6TGMs4lQ5gQC

[2] See International Integrated Reporting Council, *Capitals Background Paper for <IR>,* with contributions from the Association of Chartered Certified Accountants (AACCA) and Netherlands Institute of Chartered Accountants (NICA) (Amsterdam: International Integrated Reporting Council, March 2013), http://www.theiirc.org/wp-content/uploads/2013/03/IR-Background-Paper-Capitals.pdf

[3] A recent book by Harvard Business School professor Amy Edmondson provides an excellent analysis of the challenges facing organizations in the knowledge economy. See Amy Edmondson, Teaming: *How Organizations Learn, Innovate, and Compete in the Knowledge Economy,* Foreword by Edgar H. Schein (San Francisco: Jossey-Bass, 2012).

[4] See *Proxy Monitor 2013,* Finding 4, at http://www.proxymonitor.org/Forms/2013Finding4.aspx

[5] Heidi Welsh quoted in Catherine Dunn, "Previewing the 2013 Proxy Season's Environmental and Social Resolutions," *Corporate Counsel,* 7 March 2013, at http://goo.gl/q0ytU

[6] To access *Proxy Preview 2013,* including the array of experts who provided commentary, go to http://www.proxypreview.org/#main and http://www.proxypreview.org/report-extras/contributors/

[7] "Corporate Political Spending, Climate Risks Are Major Focus of 2013 Shareholder Resolutions, Says New Report," *Proxy Preview* Press Release, As You Sow, 7 March 2013 at http://siinstitute.org/press/2013/ProxyPreview2013_pr_20130307.pdf

[8] Bill Baue, Cary Krosinsky, Mark McElroy, "Crossing Thresholds: From Fossil Fuel Divestment to Sustainable Investment," *SustainableBrands,* 27 March 2013, http://www.sustainablebrands.com/news_and_views/new_metrics/crossing-thresholds-fossil-fuel-divestment-sustainable-investment

[9] David Grayson and Jane Nelson, Corporate Responsibility Coalitions: *The Past, Present, and Future of Alliances for Sustainable Capitalism* (Palo Alto: Stanford University Press, 2013).

[10] Robert G. Eccles, Michael P. Krzus, Jean Rogers, and George Serafeim in "The Need for Sector-Specific Materiality and Reporting Standards," *Journal of Applied Corporate Finance,* 24, no. 2 (2012): 8, http://www.sasb.org/wp-content/uploads/2012/06/JACF-Sector-Materiality.pdf

[11] IIRC background papers on materiality, the business model, and "the capitals" can be viewed and downloaded at http://www.theiirc.org/resources-2/framework-development/background-papers/

AccountAbility helps its clients and members improve business performance and build sustainable, competitive advantage by:

- → Increasing revenue
- → Mitigating risks
- → Engaging stakeholders
- → Reducing costs
- → Facilitating innovation
- → Enhancing reputation

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