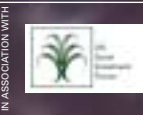


# Redefining Materiality

Practice and public policy for effective corporate reporting

Simon Zadek & Mira Merme



# Redefining Materiality

---

*'Redefining Materiality'* has been authored by Simon Zadek, AccountAbility's Chief Executive, and Mira Merme, Senior Associate of AccountAbility. The report has benefited from discussions and comments arising through extensive consultation, and we are particularly grateful to Allen White, Alun Bowen, Chris Tuppen, Eileen Kaufman, Helen Wildsmith, John Hale, Mark Mansley, Paul Burke and Paul Monaghan, Selina Haniff, Simon Killick, and members of UKSIF, the ACCA Social and Environmental Committee, the GRI Advisory Group on Assurance, and the CORE Group, who have given their time generously in commenting on drafts and specific issues. We are particularly appreciative of the editorial work of Peter Raynard and Maya Forstater, both Senior Associates of AccountAbility. The preparation of this report was made possible by the financial support of the Co-operative Insurance Society and The Co-operative Bank.

Comments on this work should be forwarded to the authors at [simon@accountability.org.uk](mailto:simon@accountability.org.uk) or [mira@accountability.org.uk](mailto:mira@accountability.org.uk).

**AccountAbility's** mission is to *promote accountability for sustainable development*. As a leading international professional institute, AccountAbility provides effective assurance and accountability management tools and standards through its AA1000 Series, offers professional development and certification, and undertakes leading-edge research and related public policy advocacy. AccountAbility has embraced an innovative, multi-stakeholder governance model, enabling the direct participation of its organisational and individual members who span business, civil society organisations, and the research community from different countries across the world.

For further information on this or related areas of AccountAbility's work visit [www.accountability.org.uk](http://www.accountability.org.uk).

**The UK Social Investment Forum (UKSIF)** is the UK's membership network for socially responsible investment (SRI). UKSIF's primary purpose is to promote and encourage the development and positive impact of SRI amongst UK based investors. UKSIF believes that all material social, environmental and ethical (SEE) issues should be integrated into standard investment practice and that individual investors should be able to reflect their values in their investments.

## Executive Summary

---

Tomorrow's effective corporate social, environmental and economic reporting must communicate information that is 'material' to stakeholders in making coherent decisions and taking planned and timely actions relevant to their interests.

An appropriate redefinition of materiality is therefore essential for business managers, for policy makers establishing tomorrow's regulatory frameworks, and for those involved in their implementation and oversight.

Materiality *is* being redefined - through pressure on business from wider civil society, and through precedents established by company practice and, increasingly, regulation and litigation. But current experimentation in redefining materiality suffers from being ad hoc, often confused and confusing, and rarely credible. As a result, companies too often disclose information that is not used, incurring unnecessary costs without satisfying intended audiences.

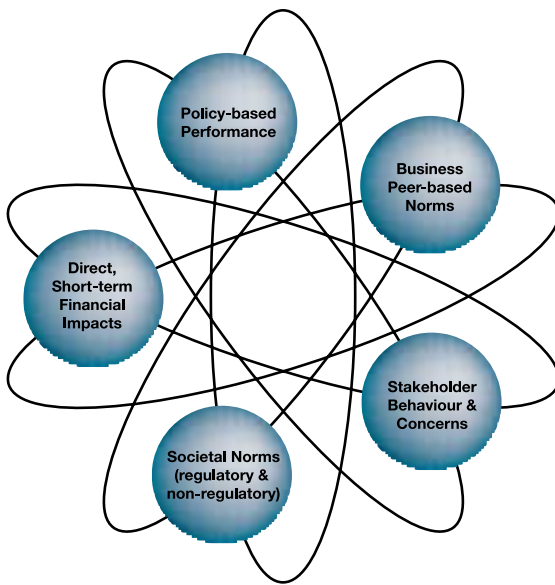
There is a critical need to redefine materiality to the satisfaction of both business and its varied stakeholders, and to codify an agreed approach to ensure its demonstrable, consistent application. This would benefit both business and its stakeholders in settling expectations, converging practice, and enabling balanced comparison.

**'Redefining Materiality'** proposes a robust, practical and effective approach that meets the needs of companies' and their stakeholders, both those advocating broader business and investor responsibilities, and those primarily focused on financial returns.

Proposed is to broaden the definition of materiality to ensure that companies are sensitive to stakeholder concerns. The proposals are based on the AA1000 Assurance Standard's materiality principle that requires that 'the reporting organisation has included in its public report adequate information about its sustainable performance for its stakeholders to be able to make informed judgments, decisions and actions'.

The report makes four related proposals for effectively implementing this redefinition of materiality:

**Figure 1: Five-Part Materiality Test**



- ✔ The application of a five-part test of materiality (Figure 1) in determining what should be publicly disclosed.
- ✔ Embedding this test in a transparent process involving companies in stakeholder engagement and appropriate analysis.
- ✔ Subjecting the test and process to external assurance by providers using appropriate standards.
- ✔ Placing the results of the test and underlying process under the direct responsibility of company boards.

AccountAbility's proposed approach can be, and in some instances is already being, used by:

- Companies in defining the scope of reports.
- Assurance providers in assessing the relevance of these reports.
- Standards developers in framing approaches to reporting, assurance and sustainability and risk management.
- Policy makers in codifying a redefinition of materiality into voluntary codes, industry standards, investor-led reporting requirements, listing requirements, and other regulations governing company behaviour.

# 1. Data, Data Everywhere...

---

*Useful reporting is not about dumping ever-increasing volumes of data into the laps, and laptops, of unprepared investors and other stakeholders.*

Making more information public can help to end the culture of secrecy and public distrust that surrounds corporate behaviour, and help rebuild the all-important social contract between business and society. More and better information is demanded both by those responsible for ensuring the financial performance of investments, and by stakeholders concerned with the wider social, environmental and economic impacts of business.

But a move towards a *'take-the-lot'* approach to disclosure is neither feasible nor desirable. Completely open books can be problematic for both legal and competitive reasons. Furthermore, approaches that result in information overload are unlikely to inform or affect the behaviour of a company or its stakeholders, the essential litmus test of effective communication. AccountAbility and CSR Europe's report, *'The Impacts of Reporting'*<sup>1</sup>, highlights the dangers of reporting becoming a costly tick-box exercise that fails to have an impact on the social, environmental or economic outcomes of corporate performance. Indeed, such developments in reporting might actually reduce trust, resulting in stakeholders believing that companies are deliberately disguising what is important, or *'hiding the wood amongst the trees'*.

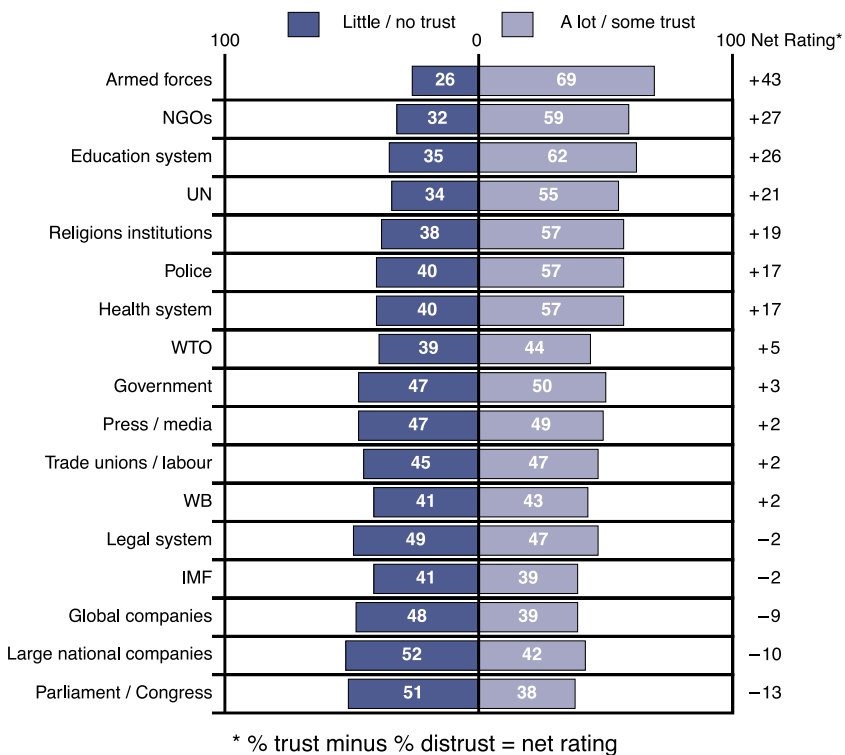


Effective public reporting must, in short, communicate what is important to targeted information users in ways that enable them to make coherent decisions and take planned and timely actions relevant to their interests whether as customer, employee, neighbour or citizen.

Obvious, perhaps, but how does this relate to practice? UNEP/SustainAbility's latest bi-annual review of corporate sustainability reporting, *'Trust Us'*<sup>2</sup>, highlights the rapid growth in the number of reports and the increasing volume of information reported.

This is confirmed by CSR Network’s fourth Benchmark survey of the social and environmental reporting of the world’s one hundred largest companies, which found an increase in reporting on health and safety, diversity, and human rights.<sup>3</sup> But despite this trend, neither campaigners nor the general public trust business to look after people or the planet. The most recent World Economic Forum (WEF) ‘trust’ survey, for example, mirrors a host of other studies that locate large businesses well towards the bottom on lists of trusted institutions.<sup>4</sup> While trusting what an organisation says to be true, and trusting it to act in society’s best interests are not the same thing, clearly we will never come near the second condition unless the first can be met.

**Figure 2: Trust in Institutions to Operate in Society’s Best Interests**



Source: World Economic Forum / Environics

---

The investment community is a key user of information published by business, and so an important audience to test the usefulness of sustainability reporting. One would expect the astonishing growth of 'socially responsible investment' (SRI) funds to mark a shift in investor attitudes towards non-financial aspects of company performance. SRI has certainly become increasingly important, as a recent Deloitte & Touche study highlights.<sup>5</sup> In the USA, it has been estimated that as much as US\$2 trillion was invested in a 'socially responsible manner' at the height of the equity boom, 13% of the US\$16.3 trillion under management. In Japan, the comparable volume was estimated at US\$2 billion, whilst the total SRI assets in Europe have increased by 36% from €11.1 billion at the end of 1999 to €15.1 billion in mid-2001.<sup>6</sup>

But despite the growth of funds taking explicit account of non-financial aspects of performance, institutional investors too often remain resistant to taking account of such issues. One major survey commissioned by Business in the Community on the 'UK investors' attitudes to environmental and social issues found that less than 5% of financial analysts and fund managers, when asked (unprompted) what they take into account in making or recommending investments, mentioned social and environmental aspects of corporate performance.<sup>7</sup> So, even though aspects of sustainable development are increasingly relevant to the corporate community and its stakeholders, the investment community still remains largely unconvinced.

This disconnect between reporting beyond short-term financial performance and investor interest is rightly a concern both for those advocating that account be taken of broader sustainable development issues, and those focused on longer-term financial returns. Campaigners are increasingly skilled in influencing the consumer markets within which business has to profitably operate. But companies will in practice not change unless investors are more consistently knowledgeable, engaged and responsive. All sides recognise that investors' interests are a key driver of company behaviour. In fact, business is unlikely to take social, economic and environmental issues properly into account unless there are clear rewards to doing so (and penalties for failure) in terms of the cost and availability of financial capital.

---

## So Why Report?

So why do companies report on their sustainability performance, why should investors care, and how far do existing approaches to reporting, meet their needs? There are three broad views on the role of public reporting in strengthening sustainability performance:

- **Stakeholder-focused reporting.** A growing range of stakeholders, largely outside of the financial community, want to take non-financial issues into account in the way they deal with companies. From this well-established corporate responsibility view, sustainability reporting is grounded in a duty of companies to account to those they impact on, including staff, customers and local communities, about issues of concern to them. The emerging trend towards corporate sustainability reporting has been largely driven by these demands.

The Global Reporting Initiative (GRI) Sustainability Reporting Guidelines is the leading, voluntary reporting standard associated with this perspective. It has been increasingly influential in informing the approaches of companies to sustainability reporting, with estimates of several thousand companies already using the guidelines in their own sustainability reporting.<sup>8</sup> Crucially, the GRI Guidelines have been developed through an iterative multi-stakeholder process focused on achieving consensus on what is important to stakeholders, and how it can best be measured.

This approach to reporting does not focus on investors, but it can be relevant to investor needs in setting out aspects of business performance that might impact on stakeholders' views and behaviour towards the company. Certainly, the GRI Guidelines define what stakeholders consider *important*,



---

and propose specific associated indicators. What these approaches do not do, however, is to establish what is *material* in any particular circumstance, a matter to which we will return.

- ***Investor responsibility-focused reporting.*** A second view focusing on *investor responsibility* argues that investors should care about broader sustainability as well as (not instead of) financial performance. Much of the ‘socially responsible investment’ movement would fit into this category, as do investors affected by legislative moves such as the UK Pensions Act (2000), which requires pension funds to report on their social and environmental policies. Most recently, for example, Insight Investments have taken a lead in advocating an investor responsibility-based strategy, proposing in particular the adoption of the OECD Guidelines for Multinational Enterprises as a basis for setting out the requirements of its investees.<sup>9</sup>
  
- ***Risk-based reporting.*** The third route to handling the interface between sustainability reporting and investor interests is to consider sustainability issues only insofar as it impacts on financial performance. It is increasingly recognised that understanding social and environmental performance can help companies and their investors predict and thereby manage risks and opportunities. This approach is both most familiar to the investment community, but also has generally been narrowly interpreted to date. What is deemed a material risk has largely been confined to those areas where there exists the potential for litigation, and where the potential outcomes are both very large financially, and within a relatively short period of time. Other approaches have begun to emerge, for example the social, ethical and environmental (SEE) risk-related reporting guidelines of the Association of British Insurers (ABI)<sup>10</sup>, which were first issued in 2001 and subsequently updated in early 2003. Although framed in fairly general terms at this stage, the ABI’s initiative has clearly signalled the relevance of SEE to risk assessment for and within the mainstream investment community.

---

All three of these perspectives and underlying approaches imply the need for greater quality of sustainability reporting. However, each approach has differing, albeit related, implications for how best to determine what to report, and so also what to ultimately disclose.

## 2. A Materiality-based Approach

---

*Tomorrow's effective sustainability reporting will have to be rooted in an agreed approach to redefining materiality.*

A 'take the lot' approach to public disclosure can certainly provide a great deal of relevant information. But such 'broadband' approaches may not include what is material, and even where they do, the significance of this information may be simply missed amongst the voluminous detail. At the same time, it is insufficient to retain an overly narrow approach to defining materiality that has the effect of excluding aspects of a company's operations, which its stakeholders, including shareholders, consider significant in making investment, employment, purchasing or public policy decisions.

Establishing what is material is not a new challenge to business. The topic has become increasingly important across the financial accountability community during the recent wave of financial reporting (and performance) fiascos. But the challenge reaches new heights when business success is influenced, within a relevant timeframe, by its social and environmental performance. Moving beyond conventional approaches to identifying what is material therefore requires new concepts and competencies. But the challenge is knowing where to begin. A wide-angle, stakeholder-based approach is impractical since it provides no basis for calibrating the relevance of stakeholders' views or the fact that they often

conflict with each other. Certainly societal preferences can be quixotic. Public debate about child labour for example, can be overshadowed when issues such as access to health care comes to the fore, only to be supplanted by high-profile spectacles such as Enron, and the personal calamities of lost livelihoods and vanishing pensions. It is hard to work out stakeholders' long-term 'climatic' views amidst the maelstrom of variable, more immediate weather conditions.<sup>11</sup>

Others counter this cautious, essentially managerialist view, in arguing that some aspects of performance are *always* material



---

because society considers them important enough to be counted. From this perspective, core aspects of a company's environmental impact, such as carbon emissions, would always be reported on. Similarly, for aspects of companies' social and economic impacts, such as those embedded within core UN declarations and conventions, or perhaps more generally accepted codes such as the OECD Guidelines for Multinational Enterprises. These 'must be' aspects of materiality will at times be context specific, and evolve over time. An example of this would be the decision of the Johannesburg Stock Exchange<sup>12</sup> to require all listed companies to report going forward on their handling of HIV/AIDS, or the UK's recent requirement for certain political donations to be disclosed, and the current proposals for all energy and mining companies to publish all details of their royalty/license payments to host governments.<sup>13</sup>

## Materiality Reassessed

The 'classical' definition of materiality as it relates to company reporting can be summarised as containing three aspects:

- ❑ **Intention – i.e. materiality to whom. Materiality is generally defined in terms of 'member interests', essentially the concerns of the owners of financial capital or their representatives.** The UK's Accounting Standards Board, for example, states that: "information is material if it could influence users' decisions taken on the basis of the financial statements."<sup>14</sup> The US's Securities and Exchange Commission (SEC), similarly, states that: "materiality concerns the significance of an item to users of a registrants financial statements."<sup>15</sup>
- ❑ **Subject - i.e. materiality about what. The classical definition of materiality assumes that the only concern of these investors is the financial performance of the company in question.** Therefore information is considered material if it can affect this financial performance whether in the long or short-term. Obviously the more a long-term view is taken of the risks and opportunities that a company faces, the wider the net of material issues becomes.

- 
- **Calibration** – i.e. how significant does an issue have to be to fall within the bounds of materiality? Here, the classical approach does not provide a clear boundary around materiality but depends on a judgement of what a ‘reasonable person’ would consider material. The US’s SEC, states: “A matter is ‘material’ if there is a substantial likelihood that a reasonable person would consider it important... The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgement of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.”<sup>16</sup> In fact the SEC further states that a fact is material if “it would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.”<sup>17</sup> Similarly, the UK’s Accounting Standards Board states that: “the materiality of the misstatement or the omission depends on the size and nature of the item in question judged to the particular circumstances of the case”.<sup>18</sup> Materiality judgments can often be hotly disputed. However, SEC SAB 99 lists a number of “qualitative factors” which might cause even small misstatements to reach the level of materiality, including whether a misstatement: (a) changes a loss into a profit or vice versa; (b) masks a change in earnings or other trends; (c) hides a failure to meet analyst expectations; (d) affects compliance with loan covenants; or (e) increases executive compensation, for example by satisfying criteria for a bonus.<sup>19</sup>

Each of these aspects of materiality, are however, now being reassessed:

- **Intention. Corporate reports, particularly environmental, social and sustainability reports are not simply aimed at shareholders and their representatives.** They are a response to demands from a growing range of stakeholders for more information about companies’ social and environmental impact. While some call for the extension of the formal ‘right to know’ beyond investors, others stress the business case for considering wider stakeholder concerns which can ultimately have an impact on shareholders’ investments. Either way the question

---

of 'materiality to whom' must now encompass a wider range of stakeholders.

- ❑ **Subject. Non-financial aspects of performance are increasingly taken to be material.** This is not surprising given the wider range of stakeholders' interests, which define the new materiality. However, investors' concerns are also broadening - most obviously in the emerging 'SRI' industry, but also more broadly in terms of forecasting the financial risks, opportunities and liabilities implied by social and environmental performance. They are further encouraged through public policy, for example the obligation of UK pension funds to report on their non-financial policies, and the South African King II Report's non-financial reporting obligations.
  
- ❑ **Calibration. While materiality will never be cut and dried, the extension of intention and subject changes the basis on which 'a reasonable person' would decide whether an issue is material or not.** There is a need to reassess the basis on which materiality is calibrated, to take into account the wider range of stakeholders, concerns and timeframes which can reasonably be considered to be material.

This reassessment has led to the development of a range of new instruments that offer alternatives, which often cut across these three aspects, and at times ambiguously so. The Dow Jones Sustainability Index, for example, offers a view of best-in-class performers according to social and environmental criteria. But the index's creators, Sustainability Asset Management, argue that the application of these criteria identify the degree to which companies are effectively managing associated risks and opportunities. The FTSE4GOOD, on the other hand, is comprised of companies drawn from the main FTSE index, but included or excluded on the basis of social and environmental best practice, exhibited in terms of their policies, processes and performance. The Operating and Financial Review (OFR) of the proposed UK Company Law frames non-financial disclosure firmly within a 'business performance' model, whilst allowing (at this stage) considerable latitude in interpreting what this can, and cannot, cover. This poses a greater risk to the liability of Board

---

directors in their decision as to what is material or not, and therefore what should be disclosed in line with the OFR.

Some mainstream players have already acknowledged this reassessment. The European Federation of Accountants (FEE), for example, states that: “materiality is a principle which is related to relevance and which is sometimes referred to as a ‘threshold characteristic’. Furthermore, what will be considered as material by one user group, may be different from the view of another group”<sup>20</sup>. New principles of disclosure and reporting, similarly, in the King II Report, now included in Johannesburg Stock Exchange state that: “Public disclosure of non-financial information should be governed by the principles of materiality, relevance, clarity, comparability, time and verifiability. Guidance in this regard could be obtained from international models and guidelines as well as national statutory definitions”. The proposals for a new UK Operating and Financial Review require company directors to understand ‘stakeholder interests’, albeit only to determine which are relevant to member interests.

The current state of reassessment is, in short, confused. Even confining the analysis to those approaches that are purely focused on risk and financial performance, reveals very differing approaches dependent, for example, on the handling of:

- **Time frames**, with typically more social and environmental issues being included where longer time periods are taken into account.
- **Emerging issues**, driving new aspects of materiality, particularly where media criticism is significant (e.g. obesity).
- **Underlying risk**, being almost entirely ignored until it actually impacts on financial performance (e.g. drug pricing).

The confusion is magnified where stakeholder-based approaches are (rightly) advocated without due attention placed on the ‘how to’. What in practice one observes are ‘gunshot marriages’ between shareholder and stakeholder approaches, leaving the company director with the accounting, governance and ultimately legal problem to ‘sort out the

---

details'. This is clearly inadequate for all concerned, although the opposite extreme - a mechanised, 'check-list' solution - will also not do. Conceptual clarity is essential, as is sufficient guidance to enable company directors to be clear as to their responsibilities and how they should be fulfilled, and for external assurance to be a practical and useful way of attesting to concerned stakeholders as to whether this has happened.

### 3. Redefining Materiality

---

*A meaningful definition of 'materiality' must effectively identify information that, if omitted or misstated, would significantly misrepresent the organisation to its stakeholders, and thereby influence their conclusions, decisions and actions.*

The proposed redefinition of materiality must, and can be, appropriate for both:

- ❑ Those who argue for business and/or investor responsibilities.
- ❑ Those focused on taking into account emerging and longer-term risks and opportunities that might impact on financial returns to investors.

This approach has been drawn from the results of several years, international consultation in the development of the AA1000 Assurance Standard.<sup>22</sup> It offers the potential for developing a body of practice in corporate public reporting that is responsive to both investors and the wider stakeholder community.

Whilst this overarching approach does address what is required, the devil is, of course, in the detail. Which stakeholders are we talking about, and what level of importance must they attach to an issue before it becomes material to the company? Also, even if the conceptual problems are sorted,

how can quality data be generated within these parameters, and what competencies must assurance providers and directors have to be able to interpret the data and make decisions on their basis? Precision is extremely important on these issues, notably for Board directors. The UK Government White Paper on the Company Law Review, for example, does not include “safe harbour” provision, that is legislative protection for directors and assurance providers, from liability in respect of statements made in good faith if they turn out to be wrong and misleading. This increases the need for directors to be able to clearly state what process they explored in order to identify the material elements for disclosure.



---

The AA1000 Assurance Standard's materiality principle is that "the reporting organisation has included in the public report adequate information about its sustainable performance for its stakeholders to be able to make informed judgments, decisions and actions."

### **Proposed Five-Part Materiality Test**

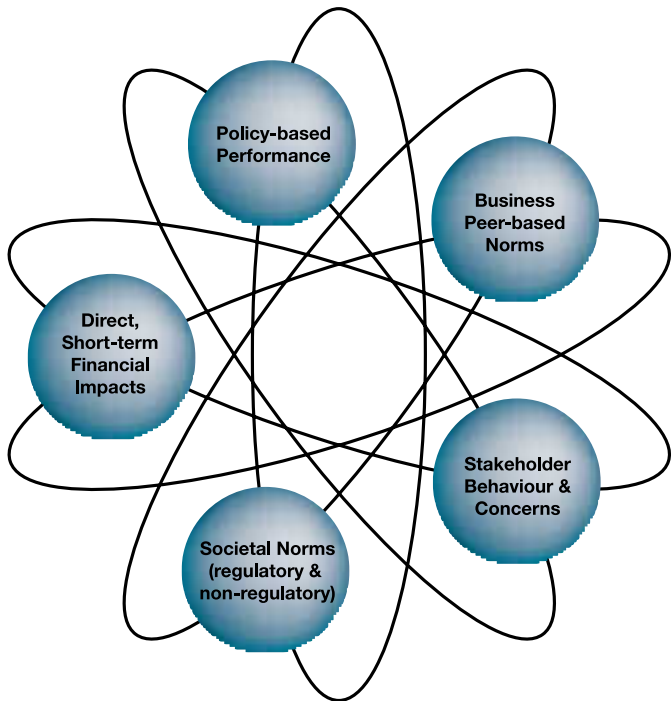
There is a clear need for a framework that establishes what is material and relates to investor and shareholder interests without pre-determining what should, and what should not count. Such a framework needs to be conceptually sound, offer clear guidance to company directors, and deliver both the precision and flexibility that will ensure that companies' can credibly evolve their understanding and practice over time as market conditions adjust to emerging societal demands and related risks and opportunities.

This report sets out four related proposals, the first of which is a distinct five-part test in deciding what to disclose within the overall framework provided by the definition of materiality set out above.

#### ***Test 1: Direct Short-term Financial Impacts***

Short-term financial impacts resulting from aspects of social and environmental performance. Carbon emissions are the clearest example in recent years of an aspect of non-financial performance that has become 'material' under this first test to an increasing number of companies. ENEL, an Italian utilities company, illustrates this in its recent filing with the US SEC (20-F), "On the basis of current forecasts of future fuel prices, we believe that application of the carbon tax as currently formulated could have a significant impact on the economic viability of our oil-fired plans by the year 2005, should the tax rates then reach their maximum levels ... In 2000 and 2001, our carbon tax liability amounted to approximately Euro 38.0 million and Euro 42.5 million respectively". This first stage test of materiality might also surface a wider set of issues and aspects of performance. For example, material issues might be identified through an assessment of expenditures linked to related lobbying and advertising, since these spends are in themselves an indication of what the Board deems material.<sup>23</sup>

**Figure 3: Proposed Five-Part Materiality Test**



**Test 2: Policy-related Performance**

Irrespective of short-term financial consequences, issues are material where the company has agreed policy statements of a strategic nature. Corporate responsibility practices have generated a jungle of corporate policy statements, often framed as core to business rather than add-ons. Tesco, for example, publicly sets out the significance of its treatment of people to its core business strategy; *“our commitment to live the Values - treating people how we like to be treated, working together as one team, and looking after our people - are what make the difference”*<sup>24</sup>. Given this, it would be unreasonable for the company not to consider this dimension of its performance in determining materiality. At the same time, the company would have to either include as material or demonstrate the immateriality of stakeholders’ views on this aspect of Tesco’s policies and practices, including for example claims by the corporate watchdog, Transnational Corporations Observatory, that the company had violated the ILO code 138 on minimum age for employment of children.<sup>25</sup>

---

This second test will certainly give companies cause for reflection as to whether it is judicious to develop and commit to policies covering social and environmental issues. Such hesitancy would be in the common interest of companies however, and would be a positive outcome of the proposed approach, since it would create an environment where policy commitments had tangible implications (if only through disclosure). This would contrast with the current situation where many companies have similar policies but quite different levels of commitment to their implementation. This test is also clearly attractive from a risk perspective, as it encourages the company to consider the gap between policy and implementation, thereby highlighting the potential for litigation, for example over misrepresentation, which is of particular relevance in the US.

### ***Test 3: Business Peer-based Norms***

The third test of materiality concerns whether a company's peers are deeming issues and aspects of performance to be of material importance. For example, access to medicine is seen as increasingly important to pharmaceutical companies. GlaxoSmithKline states concerns over elderly US citizens purchasing over the Internet non-Food & Drug Administration regulated medicines. Bristol Meyer Squibb addresses the problems of AIDS, and most recently Eli Lilly has stated that, "ensuring access to medicines requires that many organisations work together, including government, insurers, health care providers, and pharmaceutical manufacturers. Lilly will continue to lead and support efforts to improve access to our medicines."<sup>26</sup> In light of these developments, there would be significant and understandable concern on the part of the investment community were a pharmaceutical company to conclude that access to medicine was not a material issue from a risk management and reporting point of view.

This third test clearly enables leadership companies when exploring and reporting on the material dimensions of social and environmental performance to filter these issues into the wider business community. Furthermore, it mirrors today's practice of effective risk assessment and reporting, where assurance providers would normally take into account the practices of comparable companies in assessing the extent of risk for a client.

---

#### ***Test 4: Stakeholder Behaviour and Concerns***

The fourth materiality test concerns the practical definition of relevance to stakeholders in terms of reasonable evidence of likely impact on their decisions and behaviour. It is one thing to say that people care whether Marks & Spencer's deals fairly with workers in their global supply chains, but it is quite another to argue that they care enough to act, whether as investors, employees, customers or regulators. Verbal expressions of caring alone are not enough, since this would clearly leave companies vulnerable to changes in fashion and the amplifying power of the media, rather than the underlying, longer-term concerns of the people that can make or break their business.

Of course stakeholders' expressed concerns can turn into changes in behaviour, and so may be a lead indicator of what is material. The early stage of the public debate about genetically-modified organisms (GMOs) saw little behavioural response in the market, and so might not have been considered material to companies marketing GMO-based products and processes. But concerns in this case have turned into dramatic behavioural response of citizens as customers and also as voters in their impact on related public policy.

Clearly these areas are often judgement calls. Shell International chose to respond to concerns over events in Nigeria and over the Brent Spa oil platform, although there was no obvious evidence that sales or profits were measurably impacted. The company took a view that stakeholder concerns revealed potential risks and possibly pointed the way towards potential opportunities, neither of which had been picked up by the financial markets. At the same time, the company has chosen to omit the carbon emission effects of the use of its product, taking into account only those emissions from extraction through to sale. To date, the company has taken a view that these stakeholder concerns are not yet material indications. In both cases, what public reporting needs to cover is only part of the answer; what is also needed is some sense of how the company got there, in effect an assurance of due process covering method, information, competencies and impartiality.<sup>27</sup>

---

### ***Test 5: Societal Norms***

The fifth and final test of materiality concerns whether there are societal norms that a company has considered. Some of these are already embedded in regulation, and so are clearly aspects of social and environmental performance that the company will take into account (and will be picked up through the first test). A second element of this test would be those aspects of performance that are likely to become regulated in the future. In the mid-1990s, for example, the application of this element would have shown the likely advent of anti-corruption legislation emerging on the back of the OECD agreement on foreign corrupt practices. Today, carbon emissions would be a case in point, as illustrated in the case of ENEL above.

A third element would include emerging norms within the investment community with regard to their own responsibilities. The UK Pensions Act (2000) requiring pension funds to disclose social and environmental policies clearly signalled the likely future growth of such policy frameworks, which would impact on company approaches to materiality. The Association of British Insurers' (ABI) risk reporting guidelines would be another case in point, as is the active debate about stock market listing requirements in the UK, across Europe and elsewhere. The practices of leading investment houses might also signal broader changes to come, such as the new business guidelines adopted by Insight Investments outlined above. Finally, international developments might reflect strong indications of emerging societal norms, such as the UN Global Compact's nine principles<sup>28</sup>, or ongoing discussions about the potential for linking international trade and investment to social and environmental aspects of corporate performance.

Current company reporting can be categorised by one or many of these 5 tests; for example, Marks and Spencers states that "in 1999, after our customers had expressed very strong concerns about eating GM foods we took the decision to move towards non-GM ingredients and derivatives. We reviewed our entire catalogue of 3500 foods, checking over 5000 individual ingredients made from soya and maize and making changes to 1800 recipes. Our technologists travelled the world to find

---

non-GM sources of raw materials, and set up traceability schemes to enable us to track every ingredient from source to shelf.”<sup>29</sup>

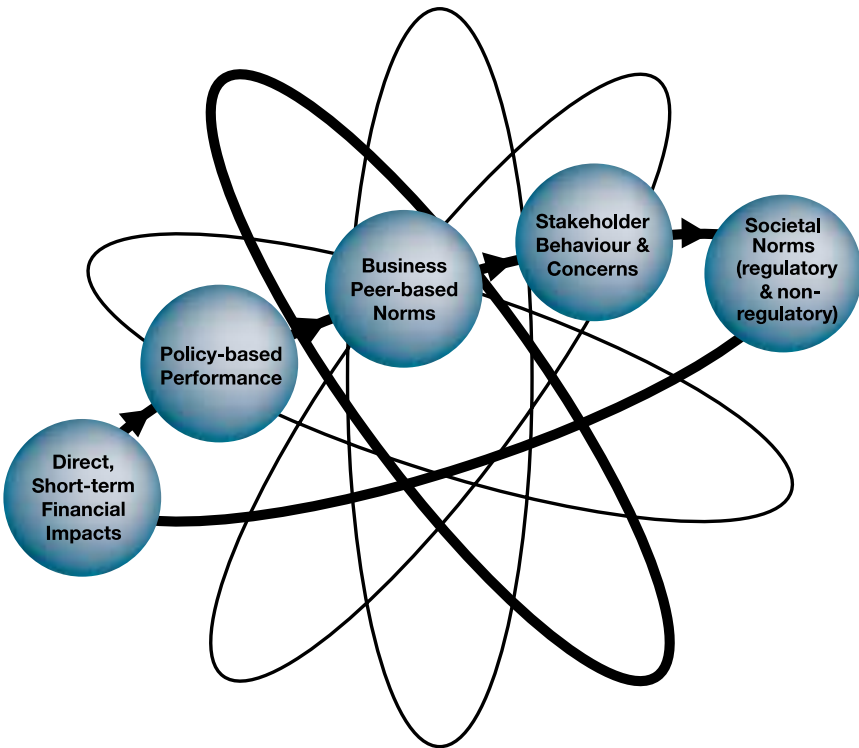
Marks and Spencers’ decision to consider the issue of genetically modified foodstuffs a material one to their business and ban GMO foods from its product lines as a response to stakeholder concerns, as well as include the ban in company policy and report it on their web site, is a decision which fits tests 2, 3 and 4.

Peer group comparison and pressure seems to have had an impact on reporting norms as companies that say they currently source all their ingredients from GMO-free crops for the food and drink they sell in Europe, include Pepsi Cola, Coca Cola, Heinz, Mars, Danone, Kellogs, Campbell Foods, Cadbury Schweppes and Kraft / Jacobs / Suchard. Almost all of these indicated that they also source GMO-free derivatives. And Europe’s top fast food chain McDonald’s Europe “have asked suppliers to source non-GM ingredients, additives and processing aids”.<sup>30</sup>

Novartis is one of the first companies to report on the social and environmental nature and contents of its research pipeline for new drugs, where it states its research and development spend as 13m Swiss Francs (\$US10m) per year on advancing medical research for the developing world and specifically Dengue Fever and Tuberculosis. This decision to report on investment in research, focused on developing country needs, appears to not be driven by financial impact, policy or peer norms but from a growing concern about societal needs, which would fit into category 5. Other pharmaceutical companies, in reviewing their peers might be expected to follow suit both in terms of reporting as well as possibly R&D investment.<sup>31</sup>

An example of tests four and five combining stakeholder concerns and corporate societal norms can be seen in the findings of the carbon disclosure project where a group of 35 institutional investors representing assets in excess of \$US 4.5 trillion wrote on the 31st May 2003 to the Chairmen of FT500 Global Index of Companies asking for the disclosure of investment-relevant information concerning their greenhouse gas emissions.

**Figure 4: Maturing Materiality**



The proposed five part test clearly links together a spectrum that goes from classical, narrow approaches to interpreting materiality through to far more inclusive, and arguably complex approaches. Proposed is for all parts of the test to be applied. However, recognising that companies are at very different stages of development in their effective management of non-financial aspects of performance, a variation might be for each company to set out a phased commitment to adopt all five parts of the test, and a requirement that their stage of adoption is clarified in public reporting.

The application of this five-part materiality test by reporting organisations and assurance processes would be relevant to both those concerned with non-financial issues for their own sake, as well as those concerned by virtue of their impact on financial performance. In addition, the proposed approach has other advantages, including:

- 
- ✔ **Strong focus on business performance.** It is focused on short and longer-term business performance because this is directly affected by stakeholder behaviour, and the implementation of company policies.
  - ✔ **Evolving boundaries.** It can cope with an evolving set of activities and outcomes to be included, unlike a definition that is grounded in specific, set aspects of social and environmental performance.
  - ✔ **Assurability.** Both aspects can be empirically tested and challenged, by managers and stakeholders and, crucially, by assurance providers.
  - ✔ **Broad applicability.** It can be applied both within a voluntary and a statutory regime, and is not in any way confined to a particular sector or region.
  - ✔ **Compatible with current legislation and reporting standards** such as Stock Market Listing Rules, Financial Services and Markets Act 2000, Companies Act 1985 and SEC.



## 4. Governing Materiality

---

*A redefined materiality must be applied in a robust and transparent manner, fall under the direct responsibility of the Board, and be subject to independent, external assurance.*

Redefining materiality is essential, but insufficient unless concepts and definitions are implemented effectively. Each of the proposed five tests of materiality, however robustly defined, has to be interpreted in context. Companies differ dramatically, as do their situations. What is material for one company will be less so for others, or less so for the same company at a different time or place. To reiterate an earlier point, this is not a matter of whether the issue is important in general terms, but how best to determine whether it is a significant aspect of a particular company's performance at a specified place and point in time.

The need to interpret the five tests in context makes the appropriate governing of their implementation of utmost importance. It is crucial to situate the responsibility for interpreting the application of the tests with a company's directors, and so collectively with its Board. Clearly, the Board needs some discretion in choosing how to fulfil this duty. A formulaic approach is not the answer to today's shortfalls in corporate governance. However, failure to give clear guidance runs the risk of Boards failing to mobilise the requisite competencies or consider the required information. The danger of a free-for-all in determining what to report, risks such a reduction in quality as to discredit the entire category of reporting, and any associated regulation. Furthermore, it would ultimately open both the company and the directors personally to uncalibrated risk, particularly in the light of growing numbers of cases of litigation in the US over the quality of corporate disclosures.

In short, neither a regulatory gap nor an overly prescriptive approach to establishing the basis on which materiality is framed, would be useful in ensuring that particular issues are assessed and reported.

The Board must demonstrate that it has considered the core dimensions of the company's performance, and sought appropriate guidance as to which if any are material and should therefore be reported. The five-part materiality test provides a sound underpinning for the required process. For example, it would be a failure of duty if a company's Board did not compare its substantive and associated reporting practice to that of its

---

main market peers. Similarly, it would be inadequate practice if the Board failed to consider the relevance of its own policies in determining what was material, the concerns of its stakeholders, and societal norms. That is not to say that each Board would reach the same conclusions; Boards may well reach very different views to those of directors of their competitors as to what is material or not. But to do so in a credible and professional manner requires a robust process that brings the relevant information to the table, involving adequate analysis by competent people. Indeed, choosing to take a different path in what to report to market peers clearly requires some explanation, both to a company's investors and other stakeholders.

The challenge is to avoid shortfalls by providing adequate rules to inform shareholders and other stakeholders and to guide and protect directors. This challenge can also be framed in terms of enabling adequate assurance. Credible reporting will clearly require an adequate form and level of assurance, all the more so if it involves investor-sensitive data or information that could be otherwise subject to litigation. Whilst the accuracy of quantitative data is more easily subject to assurance using traditional means, the matter of materiality requires innovations in assurance methods and almost certainly a significant evolution in the competencies of assurance providers.<sup>32</sup>

Even these developments, however, do not suffice in enabling adequate assurance. Put simply, the assurance providers need to know what they are assuring. One option is clearly to assure the process by which materiality is determined, essentially the approach advocated in the Operating and Financial Review of the proposed revised UK Company Law.<sup>33</sup> But even a process-based approach will eventually come head-to-head with the question of whose views count and, more importantly, on what basis. If one pharmaceutical company chooses to interpret the whole issue of drug pricing in developing countries as material, then an assurance provider would need to know why its client



---

from the same sector took a different view. Similarly, if a company spelt out in its stated policies that renewable energy was the single most important strand of its future business strategy, then any assurance provider would want to see a detailed analysis of progress in this regard. Over time, even a purely process-based approach to assurance would acquire 'substantive' characteristics, which again would make it increasingly attractive to directors to clarify in advance the rules of the game.

To be effective, the proposed redefinition of materiality must be embedded within an appropriate corporate governance framework. At the very minimum, this must include:

- ☑ An explicit process through which the tests are applied, which ensures that the required information is identified, assessed and made available to the Board.
- ☑ A Board that collectively has the necessary competencies to be able to make sound decisions on the basis of the information provided.
- ☑ An external assurance of the entire process that is independent, delivered by providers with adequate competencies, and based on standards designed specifically to handle the range and complexity of non-financial as well as financial, and qualitative as well as quantitative, information.

Fortunately, these requirements do not require corporate governance to be reinvented. What they do require, however, is for reporting requirements to be framed within clear guidance as to the broad contours of the process through which a company must go, the competencies that need to be in place, and the nature as well as the fact of external assurance that has to be applied. Guidance on such a process, and on how materiality should be defined, can underpin a growing, and increasingly credible, quality in the usefulness of corporate reporting.



## 5. Concluding Comments

---

*The practical redefinition of materiality is crucial to realigning corporate strategy and performance towards opportunities and activities that deliver progressive social and environmental outcomes, whilst simultaneously enhancing overall business performance.*

The accounting scandals surrounding the downfall of companies such as Enron and WorldCom provide signals of major changes to come in how investors and corporate managers behave and are rewarded. The long-term security and productivity of assets will ultimately be recognised as the key measure of financial performance. This may take time, for many reasons, including arguably the short-termism that still permeates much of the investment market.

This shift will not just be about a change in time horizon. It will come with adjustments to the very basis on which performance is assessed, since long-term performance assessment is more than a simple aggregation of a number of short-term issues. It involves looking beyond conventional measures of assets and liabilities to those embedded in aspects of social and environmental performance and stakeholder relationships, which may hold the key to future business success or failure. Materiality must mean companies credibly report on what people care about because these stakeholders will affect future business performance through their actions as customers, employees, investors and citizens.

The redefinition of materiality therefore, is not only of interest to those concerned with the contribution of business to sustainable development. It is also important to those with their sights firmly set on the financial performance of their investments. Indeed a company's effective communication based on a redefined materiality will underpin its ability to attract an investment community increasingly concerned with the effective management of risk and the delivery of longer-term returns.



## End Notes

---

- 1 AccountAbility/CSR Europe (2002) "Impacts of Reporting: The role of social and sustainability reporting in organisational transformation". London, AccountAbility
- 2 SustainAbility and UNEP publication (2002) "Trust Us - The Global Reporters 2002 Survey of Corporate Sustainability Reporting". London, SustainAbility. [www.sustainability.com](http://www.sustainability.com)
- 3 CSR Network (2003) "Material World – the 2003 Benchmark Survey of Global Environmental and Social Reporting". London, CSR Network.
- 4 World Economic Forum (2003) "Declining Public Trust Foremost a Leadership Problem – World Economic Forum Survey Reveals Data Before Leaders Meet in Davos". <http://www.weforum.org>
- 5 Burgess, C and Soerensen, P (2002) "Socially Responsible Investment" London & Copenhagen, Deloitte & Touche, World Summit. Survey available at [www.deloitte.co.uk/sri.pdf](http://www.deloitte.co.uk/sri.pdf).
- 6 Sustainable Investment Research International (SIRI) & CSR Europe(2002) "Green Social and Ethical funds in Europe 2002 ". <http://www.sirigroup.com/pdf/SRI-Funds-Report2002.pdf>
- 7 Business in the Community (2001) "Investing in the Future: City Attitudes to Environmental and Social Issues". London, BITC
- 8 Informal estimates from Global Reporting Initiative; see [www.globalreporting.org](http://www.globalreporting.org).
- 9 OECD 2003 "The OECD Guidelines for Multinational Enterprises" <http://www.oecd.org/daf/investment>.
- 10 Association of British Insurers (ABI) (2002) "Disclosure Guidelines on Socially Responsible Investment" London, ABI. [www.abi.org.uk](http://www.abi.org.uk)
- 11 AccountAbility (2003) "Measuring the Quality of Stakeholder Engagement", AccountAbility Quarterly: Issue 20. London, AccountAbility.
- 12 Johannesburg Stock Exchange <http://www.jse.co.za>.
- 13 See the UK government's Extractive Industry Transparency Initiative, [www.dfid.gov.uk/News/News/files/eiti\\_guide\\_a.htm](http://www.dfid.gov.uk/News/News/files/eiti_guide_a.htm)
- 14 UK National Audit Office Resource Accounts (1997) "Preparing for Audit - Part 1 - Accounting Systems, the Boundary, Accounting Policies and Materiality".
- 15 Financial Accounting Standards Board (FASB)(1988) "Financial Accounting Concepts Statement no. 2" (Basic, Inc. v. Levinson, 485 U.S. 224)

- 
- 16 FASB (1988) "Financial Accounting Concepts Statement no. 2, Qualitative Characteristics of Accounting Information".
  - 17 SEC Staff Bulletin (1999) "TSC Industries vs Northway inc 1976"
  - 18 UK National Audit Office Resource Accounts (1994) Audit Materiality ISA no. 320
  - 19 SEC (1999) "SEC Staff Accounting Bulletin No. 99 – Materiality" Securities and Exchange Commission 17 CFR Part 211 [Release No. SAB 99]
  - 20 European Federation of Accountants (FEE) (1999) FEE Discussion Paper Towards a Generally Accepted Framework fro Environmental Reporting - paper issued for comment by the Environmental Task Force of the clause 5.21 & 5.23
  - 21 King Committee on Corporate Governance (2002) "King Report on Corporate Governance for South Africa (2002)- Section 4 Integrated Sustainability Reporting –Recommendations"
  - 22 AccountAbility (2003a) AA1000 Assurance Standard. London, AccountAbility
  - 23 <http://www.cnn.com/2000/ALLPOLITICS/stories/01/06/lobbying.bill/> and <http://www.fecinfo.com/>
  - 24 <http://www.tesco.com/corporateinfo/>
  - 25 <http://www.transnationale.org/>
  - 26 <http://www.lilly.com/about/overview/access/access.html>
  - 27 AccountAbility (2003a), op cit
  - 28 UN Global Compact [www.unglobalcompact.org/](http://www.unglobalcompact.org/)
  - 29 Marks & Spencers (2003) Food Policy <http://www2.marksandspencer.com/thecompany/ourcommitmenttosociety/environment/info/food/gm/articles/howdidwe.shtml>
  - 30 Friends of the Earth (2000) "European Food Manufacturers shun GMOs" . London, FOE.
  - 31 Novartis Annual Report (2002). [www.novartis.com](http://www.novartis.com)
  - 32 AccountAbility (2003b) The State of Sustainability Assurance. London, AccountAbility
  - 33 Department of Trade and Industry (2003) "Modern Company Law for a Competitive Economy: Final Report URN 01/942 AND URN 01/943in section Regulatory Impact Assessment Operating and Financial Review" [www.dti.gov.uk](http://www.dti.gov.uk)

## Additional Reference Materials

---

1. The International Organisation of Securities Commissions (IOSCO) is the worldwide association of national securities regulatory commissions <http://www.iosco.org>
2. UK National Audit Office Resource Accounts: Preparing for Audit November 1997 Introduction Part 1: Accounting Systems, the Boundary, Accounting Policies and Materiality
3. The Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 99
4. Sarbanes-Oxley Act of 2002
5. PIRC's Press Release (2001) ([www.pirc.co.uk](http://www.pirc.co.uk))
6. Zabel, R and Benjamin, J (2002) "Modern Company Law For a Competitive Economy - Completing the Structure- Reviewing Materiality in Accounting Fraud".
7. de Bos, A and de Kimpe, M.(1995) "Materiality in Accounting: A Comparison Between the EC Directives and Three Laws In Europe - a non negligible accounting concept" Erasmus University Rotterdam.
8. Letter from The Institute of Chartered Accountants in England & Wales to Global Reporting Initiative 21 May 2002
9. HM Treasury (2002) "Explanatory Memorandum on European Community Document 11502/02" [www.hm-treasury.gov.uk/consultations\\_and\\_legislation/ria/consult\\_ria\\_european.cfm](http://www.hm-treasury.gov.uk/consultations_and_legislation/ria/consult_ria_european.cfm)
10. Global Reporting Initiative (2000) "Sustainability Reporting Guidelines on Economic Social and Environmental Performance"
11. Freshfields Bruckhaus Deringer (2001) "English Company Law Reform"
12. Letter from Fédération Général des Experts Comptables Européens (FEE) to Global Reporting Initiative 31 May 2002

- 
13. Report of the High Level Group of Company Law Experts on a Modern regulatory Framework for Company Law in Europe Brussels 4th Nov 2002
  14. Company Law Review Team Consultative Committee Meeting 27th June 2000 Note for the record
  15. Canada - Treasury Board Accounting Standard 2.2 – Materiality
  16. FESE letter to Mr. Christopher Huhne MEP, Rapporteur of the European Parliamentary Committee on Economic and Monetary Comments on European Prospectus Directive November 2001
  17. McKee, M (2001) “The Proposed Market Abuse Directive - The Legal, Policy and Financial Markets background”, British Bankers Association.
  18. Consultative Document The New Basel Capital Accord January 2001 Basel II definition 2. Materiality
  19. ACBE SECRETARIAT Department of the Environment, Food & Rural Affairs Letter to Patricia Hewitt , Secretary of State, Department of Trade and Industry 12th Nov 2001

# Notes

---



## Related AccountAbility Publications

---

**AA1000 Assurance Standard** (2003). AccountAbility

Price: £50; Member / Discounted Price: £30; plus p&p

**State of Sustainability Assurance** (2003). Cohen, J., Nacamuli, C., Zadek, S.

Price: £40; Member / Discounted Price: £20; plus p&p

**AA1000 Framework: Standard, guidelines and professional qualification: An exposure draft** (1999). AccountAbility

Price: £50; Member / Discounted Price: £30; plus p&p

**AA1000: Overview of standard and its applications** (1999).

AccountAbility

Price: £30; Member / Discounted Price: £15; plus p&p

**Measuring the Quality of Stakeholder Engagement** (AccountAbility Quarterly 19).

Price: £65; Member / Discounted Price: £20; plus p&p

**Business and Economic Development: The Impact of Corporate Responsibility Standards and Practices** (2003). Monaghan, P., Sabater, C., Weiser, J. (with Business for Social Responsibility and Brody Weiser Burns)

Price: £50; Member / Discounted Price: £25; plus p&p

**Innovation through Partnership** (2002). Sabapathy, J., Swift, T., Weiser, J., Polycarpe, M.

Price: £10; plus p&p

**Impacts of Reporting: The role of social and sustainability reporting in organisational transformation** (2002). Rubbens, C., Monaghan, P., Bonfiglioli, E., Zadek, S. (with CSR Europe)

Price: £38; plus p&p

To order any of these or other publications, please visit us at [www.accountability.org.uk/resources](http://www.accountability.org.uk/resources). Alternatively you can email us at [publications@accountability.org.uk](mailto:publications@accountability.org.uk) or call us on +44 (0) 20 7549 0400.

---

Tomorrow's effective social, environmental and economic corporate reporting will communicate information that is 'material' to stakeholders in making coherent decisions and taking planned and timely actions relevant to their interests.

**'Redefining Materiality'** sets out innovative proposals for establishing 'materiality' to ensure effective reporting:

- ✔ The application of a robust, five-part test of materiality that effectively integrates traditional models of materiality with approaches that enable the relevance of diverse stakeholder interests to be determined in deciding what should be publicly disclosed.
- ✔ Embedding this test in a transparent process involving companies in stakeholder engagement and appropriate analysis.
- ✔ Subjecting the test and process to external assurance by providers with necessary competencies using appropriate standards.
- ✔ Placing the results of the test and underlying process under the direct responsibility of company boards.

These proposals are relevant to:

- Emerging regulations governing risk-related corporate reporting and stock exchange listing requirements, and specifically the UK Government's proposed Operating and Financial Review requiring companies to disclose social and environmental performance relevant to members' interest.
- Business practitioners responsible for internal assurance, public reporting for risk and other purposes, and Board-level reporting.
- Assurance providers assessing the quality of corporate reports.

**'Redefining Materiality'** is one element of AccountAbility's work in developing practical standards that promote accountability for sustainable development, building on its innovative AA1000 Assurance Standard. AccountAbility's broader work programme and other publications can be reviewed at [www.accountability.org.uk](http://www.accountability.org.uk).

Price: £40; Discounted Price: £20

