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Sustainability Materiality Matrices Explained

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Companies use the concept of materiality to guide their sustainability strategic planning processes. A material sustainability issue is an economic, environmental, or social issue on which a company has an impact, or may be impacted by. It may also be one that significantly influences the assessments and decisions of stakeholders. Sustainability reporting, unlike financial reporting, is currently a voluntary exercise and the overall process is largely left up to company. It is generally recognized best practice that a company report on the relevant (or 'material') issues that have a direct or indirect impact on its ability to create or maintain or erode economic, environmental, social value for itself, its stakeholders, the environment, and society at large.

It is important to draw a distinction between the concept of materiality as it refers to financial reporting, and the concept of materiality as it refers to sustainability reporting. With respect to financial reporting, information is deemed material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements (IASB Framework).

In contrast, in the sustainability context, the term materiality refers to those issues that can have significant repercussions on the company (both positive and negative). As of yet, no formal monetary threshold has been applied to determine what is/what is not material.

For example: The issue of water scarcity is generally considered to be a material issue for beverage companies like PepsiCo. PepsiCo relies on water to produce its products, and without a consistent supply of inexpensive water, would likely face significant business challenges. Because other people rely on the same water resources, PepsiCo may face pressure from stakeholder groups who object to its sourcing of water from communities in water-stressed regions.

Thus, water scarcity is a material issue to PepsiCo's corporate and sustainability efforts because:

- The company's sales and profitability are at stake should water become scarce or economically unavailable
- The company's actions impact water availability (i.e. PepsiCo takes water from communities that may rely on it for other purposes)
- Stakeholder groups care about water scarcity and PepsiCo's policies and management of the issue.

Materiality Process

Overview

There is no one way to conduct a materiality assessment. Many companies rely on external consultants to help them, while other companies, with more robust sustainability teams, manage the process themselves. Using an external consultant can sometimes add credibility to the process, and ensure that the company is not simply listing its well-managed issues as most material. Hiring external consultants can also help with collecting stakeholder feedback, as some stakeholders may be wary about speaking directly to the company, particularly on controversial topics.

Generally, the process for conducting a materiality assessment includes the following steps:

- Identify key issues, categorize issues relevant stakeholder groups, and business drivers
- Collect data from internal and external stakeholders
- Map and prioritize the issues

- Align the issues with management and business vision
- Develop the strategy

Phase 1: Identify key issues, relevant stakeholder groups, and business drivers

In this phase, the company develops a long list of issues. This could be culled from a variety of sources including its last materiality matrix, issues listed in sustainability reporting frameworks (e.g. GRI, SASB), and peer company sustainability reports.

The variety of issues that could be classified under sustainability (which range from greenhouse gas emissions to gender diversity of employees) can make it daunting for a company to address and manage all of them. Using a standard process for conducting a materiality assessment, a company can identify and prioritize the issues that are most material to its business and most relevant to its stakeholders. The issues that appear on a companies' materiality matrix are all expected to be managed at some level; the mapping and prioritization exercise can help a company identify where it needs to focus and with whom it could partner. By regularly repeating the process, companies can also uncover 'fast moving' issues, or issues that stakeholder groups may increasingly care about; enabling companies to proactively identify and get in front of a material issue, and develop collaborative relationships with stakeholders to work on solutions.

Stakeholder groups are identified based on the credibility and relevance of their work on material ESG issues. It is considered best practice to speak to a holistic set of stakeholders who can provide expertise on the issues identified. Companies should not avoid critical non-governmental organizations (NGOs) in the process.

Finally, the company identifies the relevant business drivers it wishes to weigh its material ESG issues against such as risk reduction, customer satisfaction, revenue enhancement, and employee retention.

Phase 2: Collect data from internal and external stakeholders

The process then moves to the data collection stage, during which key management and business leaders are asked to weigh a list of issues by their relative importance. For example, if PepsiCo's leaders were asked to assess the issue of water scarcity, they would need to ask themselves "How might the issue of water scarcity impact our ability to [drive revenue/reduce risks/enhance employee retention]?" Answers help the assessment team understand the relative importance of an issue such as water scarcity in driving business success.

External stakeholders can also be asked to prioritize issues based on relative importance. For example, an environmental NGO might say that water scarcity is the most important issue for a company like PepsiCo, whereas a human rights NGO might say it is labor rights in the supply chain. Soliciting stakeholder feedback is a crucial part of a materiality assessment. It helps to get third-party perspective and adds credibility to the process. A company will generally publicize that it consulted experts in the field and used that engagement to guide its process.

Phase 3: Mapping and Prioritization

In this step, all of the data collected from internal and external stakeholders is put into a model or framework (generally with a quantitative ranking component) and transformed into a quantitative score that can be used to map and prioritize issues. It is important to note, that while it is useful to make the

mapping process quantitative and 'scientific', it is a process that is more 'art' than 'science'. Meaning, while it is helpful to rely only on the quantitative output, many companies will take a look at the initial outputs and then realign issues accordingly.

Phase 4: Alignment with key management and strategy development

Once the final matrix is determined, it is presented to key executives and managers for review. From there, final changes to the matrix can be made. The company then embarks on the strategy development process, outlining how it will work on the identified material issues, and developing metrics to track impact. It generally will return to the key stakeholder groups to present and discuss the matrix. In general, companies revisit their materiality matrix every two years.

Phase 5: ***Reporting on Progress***

Most leading companies publish annual sustainability reports to report on progress. These reports generally refer back to the materiality matrix and the sustainability strategy and provide an update on key metrics and targets. Most reports also include narrative on targets missed, or goals not achieved, and they usually feature testimonials from stakeholders on collaborations they've pursued with the companies. Many companies use GRI as their reporting framework, and will state that their report is written in accordance to GRI standards, or will go a step further and have their report GRI-verified. Other companies will also have certain elements of their data (mainly environmental data) audited by accounting firms, similar to financial statements.

Note: Categorizing Issues and Terminology

It is important to understand the terminology companies use to categorize issues.

The term "ESG" stands for Environmental, Social and Governance, and is primarily used in the financial services industry. Investors and asset managers evaluate ESG criteria when selecting companies in which to invest. Investors often rely on data providers (i.e., MSCI, Sustainalytics, etc.) who compile publically available information on companies' sustainability and financial performance and provide this data to investors to help guide their analysis.

In addition to 'ESG', companies may also use the terms 'People Planet Profit', 'Economic, Environmental and Equity issues', 'Environmental, Social and Economic' to categorize sustainability issues. It matters less which nomenclature companies choose to use, and more that they stick to one, and are consistent in its use. Furthermore, some issues could be categorized into more than one category, and companies must make a decision on how they choose to categorize an issue.

For example, the issues of 'corporate board composition' or 'executive pay' might be considered by one company as pertaining to the 'Governance' category, whereas another company could view this as pertaining to the 'Social' category, similar to the issue of gender composition on boards and compensation parity. It is less important whether these issues are categorized as an 'S' or a 'G' issue or as a 'People issue or a 'Social' issue, and more that the company picks a categorization approach and uses it consistently, and defines how it thinks about an issue.

Overview of Frameworks

There are several key frameworks that companies use to develop an understanding of the key materiality issues they should consider and report on. The frameworks each have a different purpose, audience, and articulation of the materiality concept.

CDP: CDP, formerly the Carbon Disclosure Project, runs the global disclosure system that enables companies, cities, states and regions to measure and manage their environmental impacts. Companies self-report data related to carbon emissions and water, among other environmental issues. CDP does not emphasis materiality as much because it is primarily focused on getting companies to disclose key environmental data; it is not focused on a holistic set of sustainability issues. **Primary Audience:** Investors, ESG data providers

GRI: GRI is a "international independent standards organization that helps businesses, governments and other organizations understand and communicate their impacts on issues such as climate change, human rights and corruption." Materiality refers to an organization's significant economic, environmental and social impacts, or to issues that substantively influence the assessments and decisions of stakeholders. **Primary Audience:** Sustainability practitioner community, stakeholders, investors, ESG data providers

IIRC: The International Integrated Reporting Council (IIRC) is a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs. The coalition is promoting communication about value creation as the next step in the evolution of corporate reporting. Its mission is to establish integrated reporting and thinking within mainstream business practice as the norm in the public and private sectors. An issue is material if it could substantively affect the organization's ability to create value in the short, medium and long term. The process of determining materiality is entity specific and based on industry and other factors, as well as multi-stakeholder perspectives. **Primary Audience:** Investors; Note, Mainly European and internationally focused, less prevalent in US.

SASB: The Sustainability Accounting Standards Board sets industry-specific standards for corporate sustainability disclosure, with a view towards ensuring that disclosure is material, comparable, and decision-useful for investors. SASB standards address sustainability topics that are likely to be material and to have material impacts on the financial condition or operating performance of companies in an industry. In identifying sustainability topics, SASB applies the definition of "materiality" under U.S. securities laws. **Primary Audience:** Investors

Emerging Trends

The concept of materiality and sustainability strategy setting and reporting will continue to grow and be important. More and more companies are developing sustainability teams, focusing on materiality, and issuing sustainability reports. Trends shaping this growth include:

- ***Increasing demand for transparency:*** Through social media, any individual stakeholder group can report on corporate transgressions. Companies recognize that they need to get out in front of issues and be transparent about how they are tackling their most material challenges..
- ***Growing investor demand****:* 1 in 5 dollars in the US is invested with ESG principles in mind, and the next generation of investors (millennials) are interested in ensuring that their money is invested with an ESG focus. Given this, investors are asking for more information from

companies about their sustainability efforts. As a result, companies will need to continue to focus on identifying their most material issues, developing strategies to address them, and reporting on progress.

- ***More regulation and legal challenges****:* Major institutional investors like BlackRock and Vanguard are taking legal action against companies like ExxonMobil for failing to disclose climate risk exposure. Federal regulation was passed requiring companies to disclose exposure to conflict minerals. While regulating sustainability reporting is not on the current horizon, these signs indicate that there is increased pressure and demand for companies to disclose information that investors, and perhaps soon regulators, view as financially material to their performance. These legal actions, and regulations, are also signs that investors increasingly recognize the link between good ESG performance and management and financial performance.
- ***Growing consensus on standards, but still room for customization***: Unlike financial disclosures, sustainability disclosures are not regulated or mandatory which means that companies can pick and choose which frameworks they use, and how they choose to define their most material issues. While groups such as SASB are attempting to streamline the list of issues companies report on, and to make disclosure part of financial filings, it remains to be seen if that effort will succeed. Leading companies use a combination of SASB, GRI, CDP and their own reporting methodologies to define issues and report on progress. Investors, data providers, raters and rankers ask companies for their own bespoke sets of information. There is a growing sense of fatigue among companies about the amount of data they are asked for by different parties, and this may lead to adoption and consensus adoption of one framework and set of standards.
- ***Increasing sophistication around managing stakeholders***: Companies will continue to engage with stakeholders in meaningful collaborations, recognizing that it is better to work with relevant groups then to face possible attacks from them.
- ***ESG reporting begins to link to financial performance***: Sustainability reporting is currently decoupled from financial reporting. That is, companies report on environmental goals and targets (i.e. emissions reduced) but present these data without connection to financial metrics. Did a reduction in emissions help the company enhance its brand reputation? If so, by how much, and what dollar value can be applied to it? Without a link to financial performance it is hard to know if these metrics and the efforts placed on implementing sustainability strategies will continue to get the recognition and attention within companies and the broader investor community. There is growing interest in monetizing the business case for sustainability.

Appendix

Exhibit A: Materiality Matrix from UPS

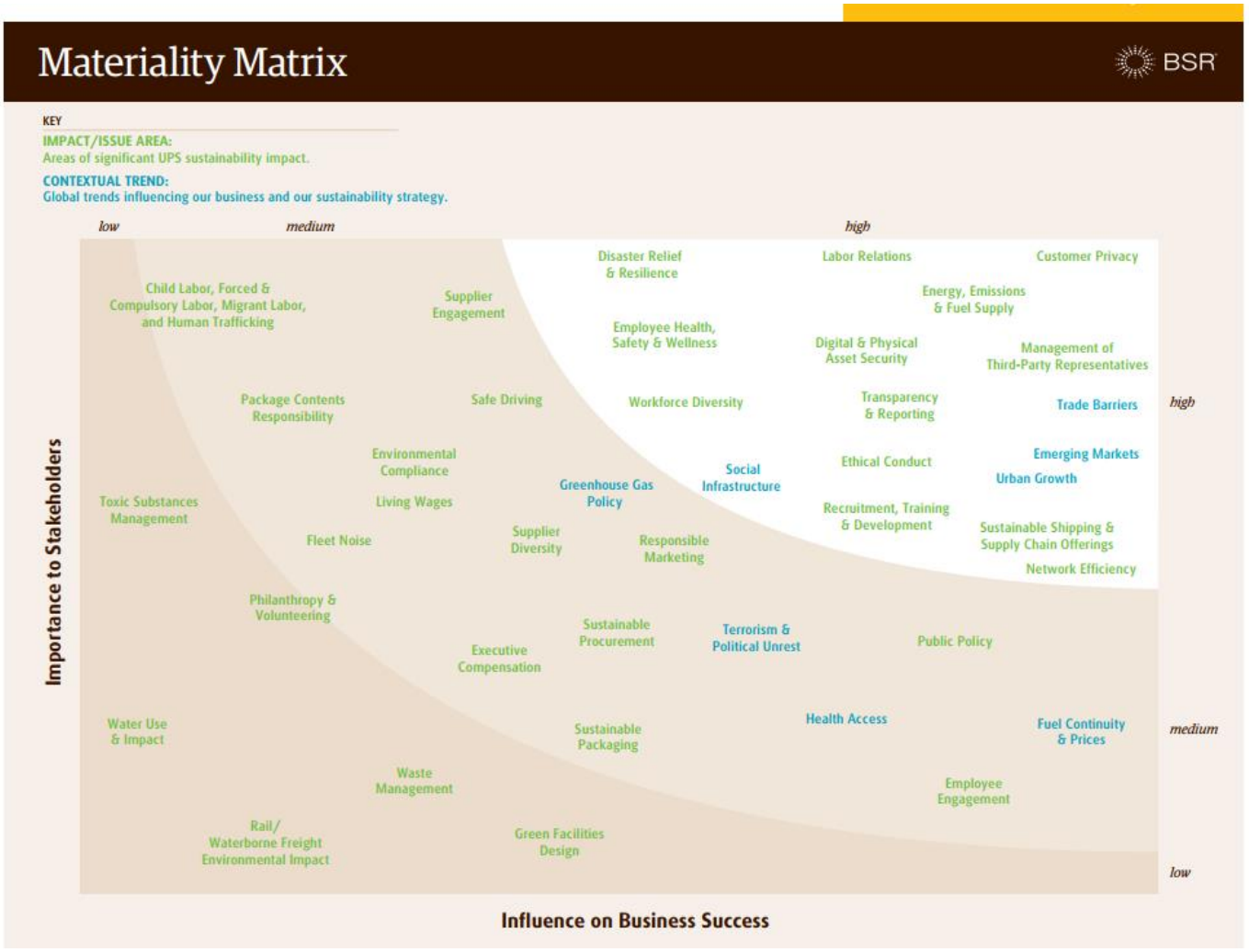

Exhibit B: GRI Material Issue Categories

CATEGORIES AND ASPECTS IN THE GUIDELINES				
Category	**Economic**		**Environmental**	
Aspects[III]	• Economic Performance • Market Presence • Indirect Economic Impacts • Procurement Practices		• Materials • Energy • Water • Biodiversity • Emissions • Effluents and Waste • Products and Services • Compliance • Transport • Overall • Supplier Environmental Assessment • Environmental Grievance Mechanisms	
Category	**Social**			
Sub-Categories	**Labor Practices and Decent Work**	**Human Rights**	**Society**	**Product Responsibility**
Aspects[III]	• Employment • Labor/Management Relations • Occupational Health and Safety • Training and Education • Diversity and Equal Opportunity • Equal Remuneration for Women and Men • Supplier Assessment for Labor Practices • Labor Practices Grievance Mechanisms	• Investment • Non-discrimination • Freedom of Association and Collective Bargaining • Child Labor • Forced or Compulsory Labor • Security Practices • Indigenous Rights • Assessment • Supplier Human Rights Assessment • Human Rights Grievance Mechanisms	• Local Communities • Anti-corruption • Public Policy • Anti-competitive Behavior • Compliance • Supplier Assessment for Impacts on Society • Grievance Mechanisms for Impacts on Society	• Customer Health and Safety • Product and Service Labeling • Marketing Communications • Customer Privacy • Compliance

Exhibit C: SASB Material Issues for Investment Banking Sector

TOPIC	ACCOUNTING METRIC	CATEGORY	UNIT OF MEASURE	CODE
Financial Inclusion & Capacity Building	Percentage of new accounts held by first-time account holders	Quantitative	Percentage (%)	FN0101-01
	Percentage of total domestic loans for underserved and underbanked business segments	Quantitative	Percentage (%) in U.S. dollars ($)	FN0101-02
	Number of participants in financial literacy initiatives for unbanked, underbanked, or underserved customers[7]	Quantitative	Number (#)	FN0101-03
	Loan-to-deposit ratio for: (1) Overall domestic lending (2) Underserved and underbanked business segments	Quantitative	Ratio in U.S. dollars ($)	FN0101-04
	Loan default rates for: (1) Overall domestic lending (2) Underserved and underbanked business segments	Quantitative	Rate in U.S. dollars ($)	FN0101-05
Customer Privacy & Data Security	Number of data security breaches and percentage involving customers' personally identifiable information[8]	Quantitative	Number (#), percentage (%)	FN0101-06
	Discussion of management approach to identifying and addressing vulnerabilities and threats to data security	Discussion and Analysis	n/a	FN0101-07
Management of the Legal & Regulatory Environment	Amount of legal and regulatory fines and settlements associated with financial industry regulation and percentage that resulted from whistleblowing actions[9]	Quantitative	U.S. dollars ($), percentage (%)	FN0101-08
	Number of inquiries, complaints, or issues received by the legal and compliance office through an internal monitoring or reporting system, and percentage that were substantiated[10]	Quantitative	Number (#), percentage (%)	FN0101-09
Systemic Risk Management	Results of stress tests under adverse economic scenarios,[11] including the following measures (actual and projection): (1) Loan losses (2) Losses, revenue, and net income before taxes (3) Tier 1 common capital ratio (4) Tier 1 capital ratio (5) Total risk-based capital ratio (6) Tier 1 leverage ratio	Quantitative	U.S. dollars ($), ratio in U.S. dollars ($)	FN0101-10
	Basel III Liquidity Coverage Ratio (LCR)	Quantitative	Ratio in U.S. dollars ($)	FN0101-11
	Net exposure to written credit derivatives	Quantitative	U.S. dollars ($)	FN0101-12
	Level 3 assets: (1) total value and (2) percentage of total assets	Quantitative	U.S. dollars ($), percentage (%)	FN0101-13
	Skewness and kurtosis of trading revenue	Quantitative	n/a	FN0101-14
Integration of Environmental, Social, and Governance Risk Factors in Credit Risk Analysis	Discussion of how environmental, social, and governance (ESG) factors are integrated into the lending process	Discussion and Analysis	n/a	FN0101-15
	Discussion of credit risk to the loan portfolio presented by climate change, natural resource constraints, human rights concerns, or other broad sustainability trends	Discussion and Analysis	n/a	FN0101-16
	Amount and percentage of lending and project finance that employs: (1) Integration of ESG factors (2) Sustainability themed lending or finance (3) Screening (exclusionary, inclusionary, or benchmarked) (4) Impact or community lending or finance	Quantitative	U.S. dollars ($), percentage (%)	FN0101-17
	Total loans to companies in the following sectors/ industries: Energy/Oil&Gas, Materials/Basic Materials, Industrials, and Utilities	Quantitative	U.S. dollars ($)	FN0101-18