

MATERIALITY AND THE ROLE OF THE BOARD

By Robert Eccles & Tim Youmans

Boards need to be clear about who they see as their significant audiences for the purposes of corporate reporting, argue Robert Eccles and Tim Youmans.

Companies face an increasing avalanche of reporting requests and requirements. Financial reporting by listed companies or reporting to industry regulators is required. Most reporting is requested by stakeholders, and companies can choose whether to comply with these requests or not, as in the general case of sustainability reporting. Integrated reporting is another example, although in an earlier stage of development. Then there are the endless requests to fill out surveys for determining membership on a stock exchange sustainability index and for rankings of sustainability and best place to work, and many more.

However, more and more companies are reporting out of stakeholder pressure and of their long term self-interest. While the company can “Just say no,” many are reluctant to do so out of concern for their reputation, brand, and stakeholder (especially employee) reaction.

In response to these reporting pressures, companies rightly assert that they should only have to report what is “material,” i.e. report on those performance indicators management believes will enable it to create value over the short, medium, and long term. Fair enough. Yet companies also give very little guidance on how they determine what is material, whether for financial, sustainability, or reporting purposes.

We believe they can't have it both ways. Yes, it's appropriate to reduce reporting of immaterial information.

It helps eliminate clutter (aka “greenwashing”). But in order to do this, the company must disclose its materiality determination process. Materiality, in its essence, is entity-specific, audience and time frame dependent, and ultimately based on the judgment of the board of directors.

This should begin with an annual board “Statement of Significant Audiences and Materiality (The Statement)”. This would be a simple one-page annual declaration, issued by the company's board of directors, that clearly and concisely articulates the significant audiences for the upcoming year or more and the time frames the company uses in evaluating its impact on them. The Statement would help determine what information is material for external reporting purposes and enables the company to properly frame the dialogue it has with its investors, other significant audiences, and all other stakeholders. Doing this requires that the board makes the tough choice of being transparent about which audiences are significant and which are not.

Fiduciary duty

The board's duty is to the interests of the corporation itself. As a separate legal entity, a corporation has two basic objectives: to survive and to thrive. Shareholder value is not the objective of the corporation; it is an outcome of the corporation's activities. While shareholders entrust their stakes in a corporation to the board of directors, shareholders are just one audience among others that the board may consider when making decisions on behalf of the corporation. The Statement is a clear and strong way to articulate the company's role in society, under

their duties of care and loyalty to the corporation. In the U.S, director duty to shareholders is co-primary with the duty to the corporation.

Transparency into the board's strategic focus enables stakeholders – including shareholders – to make informed choices in their own relationship with the corporation

Strategic focus

While the company needs to recognize the legitimate needs of all of its stakeholders, saying “We will create value for our shareholders by meeting the needs of all of our stakeholders” sounds appealing but is impossible. The corporation has limited resources and competencies to deploy against all capitals—financial, manufactured, intellectual, human, social and relationship, and natural—and must set priorities.

Considering all possible combinations of issues and stakeholders along financial and nonfinancial dimensions (i.e. environmental, social and governance issues), with current and future time frames, would make the directors' fiduciary task impossible.

Thus, the board should focus on which audiences can help the corporation create value over the short, medium, and long term. The Statement provides transparency into the board's strategic focus and enables stakeholders – including shareholders – to make informed choices in their own relationship with the corporation.

Significant audiences

The board's choice of "significant audiences" determines the issues that are "material" to the ability of the corporation to sustain itself over a self-defined period of time. Based on this, management then determines the specific issues and key performance indicators for reporting purposes. Significant audiences certainly include shareholders, but others can be critical as well, such as employees, a certain class of customers or suppliers, particular regulatory agencies, and NGOs representing various interests of civil society.

By clearly and concisely identifying the company's significant audiences — and, by implication, those that are not significant to the material issue determination process — the Statement enables all stakeholders to understand the board's approach to resource allocation and priorities. Audiences not deemed significant will object and will take actions to become significant. That is their right. The corporation has an obligation to engage with them but it does not have an obligation to agree with them. Over time, significant audiences may no longer be so while others may become so.

Time frame determination

A ten-year horizon is very different than a one-year horizon. Again, the board, entrusted with the interests of the corporation, has the right to make this audience time frame determination and should be transparent about what it is. Directors may choose to focus mainly on short-term investors and issues that are only material for short-term financial performance. Or, it may consider other stakeholders to be a significant audience and this implies that a broader range of issues, over a longer time frame, will be considered in determining materiality.

Investor demand

Interest in the mainstream investment community in a company's performance on its material ESG issues and how these affect financial performance is growing rapidly. Asset owners are becoming more sophisticated at "ESG value integration" and will become more so as better information on nonfinancial performance becomes available. Asset owners are also beginning to evaluate their asset managers in terms of their ESG integration abilities.

Companies need to respond to this opportunity by clearly articulating to investors what information it deems to be material. This begins with the board publishing The Statement. For a board that believes in long-term value creation, publishing The Statement sets up a line of defense helping to protect management from those investors interested only in short-term returns.

Value proposition

The corporation, as a separate legal entity, can survive many generations. The value proposition for the Statement is two-fold. First, by having the courage to name only a small set of significant audiences and disclosing its materiality determination process, the board sends a powerful signal on its willingness to exercise its judgment and ability to govern. Increasingly such governance signals are correlated to long term value preservation. Second, the board is seizing control of its corporate reporting, enhancing its relevance and transparency while reducing the amount of resources devoted to immaterial reporting. The Statement fosters a strategic focus on the most material audiences for long-term performance and a meaningful dialogue across the business and with the investment community.

Shareholder value is not the objective of the corporation; it is an outcome of the corporation's activities



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