Material or Not: That is the Question in ESG Reporting
In This Thought Piece

In this thought piece we explore the evolving concept of materiality within the world of corporate environmental, social and governance (ESG) reporting and four “types” of materiality that have emerged: financial materiality, impact materiality, double materiality and dynamic materiality.

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Contents

In This Thought Piece 2
Benchmark for ESG Materiality with the Argyle Disclosure Database 2
Introduction: Material or Not, That is the Question 3
Conceptions of Materiality within the SEC 5
Examples of Materiality in ESG Reports 6
To Thy Own Self Be True 8

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Introduction: Material or Not, That is the Question

“To be or not to be,” one of Shakespeare’s most iconic questions, also belongs center stage in corporate environmental, social and governance (ESG) reporting – namely, whether ESG information is material and worthy of public disclosure.

From a corporate reporting standpoint, the concept of materiality is grounded in the idea that companies should disclose to investors information they need to make decisions. Through regulations, guidance and case law, U.S. securities law has defined what constitutes materiality for the purpose of filing documents with the Securities and Exchange Commission (SEC). Information is deemed “financially material” if there is a substantial likelihood that a “reasonable investor” would consider it important to their decision-making around buying or selling securities or issuing shareholder votes.1 As the Sustainability Standards Accounting Board (SASB) explains, “...in many jurisdictions, [materiality] is the basis for determining whether a company may be exposed to fines or lawsuits for making a false or misleading statement about a material matter or for omitting information about a material matter.”2

For decades, however, a growing number of investors, asset managers, employees, non-governmental organizations, and other stakeholders have been asking companies to go beyond SEC-mandated financial materiality in their reporting. They recognize that managing ESG risks poorly around issues like climate change, human capital and business ethics could lead to increased costs and liabilities – and that managing such risks well and innovating around them could lead to positive returns. This movement, which has gained significant momentum in recent years, has expanded the realm of what companies are considering material, especially as they strategize on long-term value creation and risk management.

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Originally defined by the Global Reporting Initiative (GRI) in 2011, “impact materiality” (or “environmental and social materiality”) reflects an organization’s significant economic, environmental, and social impacts – even if such impacts are not (yet) financially material. In 2019, the European Commission began requiring companies to report disclosures that are doubly material in order to understand both a company’s “development, performance and position” (financial materiality) and its “external impacts” (impact materiality). By the end of 2020, 96% of the 250 largest companies globally (the G250) were reporting on their sustainability performance, with 73% of the G250 and 67% of the N100 (5,200 companies comprising the largest 100 firms in 52 countries) using the GRI framework and its definition of impact materiality.\(^3\)

In the United States, debate continues in some circles around what ESG topics might be material for public disclosure and if such disclosures should be regulated. In 2021, the SEC announced it would begin analyzing the accuracy, gaps and misstatements in public company disclosures around climate risks and other ESG factors, and is set to propose rulemaking on climate risk and human capital management disclosures sometime this year.

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\(^4\) KPMG. (December 2020). The Time Has Come: 2020 KPMG Survey of Sustainability Reporting.
Conceptions of Materiality within the SEC

Not all SEC Commissioners agree on whether ESG information is financially material to investor decisions – or if the SEC should specify such disclosures.⁵

On the one hand, Commissioners Hester Peirce and Elad Roisman have stated that they do not think that ESG issues are financially material, nor should they be part of securities laws – unless Congress mandates their disclosure and until one set of investor ESG expectations and comparable metrics exists (as they do in financial reporting).

On the other hand, former Acting Chair Allison Herron Lee has stated that “the idea that the SEC must establish the materiality of each specific piece of information required to be disclosed in our rules is legally incorrect, historically unsupported, and inconsistent with the needs of modern investors, especially when it comes to climate and ESG.”⁶

And, without using the exact term, SEC Chairman Gary Gensler explained the concept of dynamic materiality at the Principles for Responsible Investment’s “Climate and Global Financial Markets” webinar in July 2021:⁷

“Over the decades, there’s been debate about disclosure on things that, today, we consider pretty essential for shareholders. The first disclosures revolved around companies’ financial performance. Then, there was investor demand for information about who runs the company. Later, investors wanted more information on how much a company’s resources were dedicated to paying those executives... Of course, there was opposition to many disclosure requirements that have become so integral to our regime that it’s hard to imagine investors making a decision without them. So why am I talking about climate risk? Simple: because investors are. Today, investors increasingly want to understand the climate risks of the companies whose stock they own or might buy. Large and small investors, representing literally tens of trillions of dollars, are looking for this information to determine whether to invest, sell, or make a voting decision one way or another.”

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Examples of Materiality in ESG Reports

Given the evolving nature of ESG and materiality, how have U.S. companies been disclosing ESG information that they determine is material to their business?

Some use tables, Venn diagrams, or other infographics to list material ESG topics grouped under the headings of environmental, social or governance and/or under the types of stakeholder groups that identified the issues as impactful.

Left to right, top to bottom: Citigroup Inc., Healthpeak Properties and Broadcom use tables or Venn diagrams in their latest ESG annual reports to show ESG issues material to their businesses and stakeholders.
A growing number of companies use materiality matrices to show how ESG topics identified by the business as material compare to those identified by stakeholders. Companies then prioritize those issues that are most important to both.

*Left to right, top to bottom: HPE, Walgreens Boots Alliance and ADM use matrices in their latest ESG annual reports to show ESG issues material to their businesses and stakeholders.*

Some also include a brief statement to note that the term “materiality” used within the context of their ESG reporting is not the same as the concept of financial materiality used for SEC reporting purposes, while some avoid using the term altogether, especially if they have not yet conducted a materiality assessment grounded in investor and other stakeholder input.
To Thy Own Self Be True

Regardless of how companies are disclosing what they determine are their material ESG issues, what’s clear is that the concept of materiality is not static. Dynamic materiality captures the idea that as external and internal factors impacting companies and their investors change over time, so too does what is material:

“Due to factors such as emerging technologies, new knowledge, and new regulations companies adapt their products and services and entire industries evolve. These factors taken together with changing social expectations mean that what is material for an industry will change. There can also be differences at the company level within an industry due to different strategies.”

While research has shown that greenhouse gas emissions, labor practices and business ethics have constituted a steady 25% of all ESG disclosures from companies in the Russell 3000 since 2009, issues like employee engagement, health and safety – alongside diversity, equity and inclusion – have risen quickly in importance due to the global COVID-19 pandemic and racial justice movements. It remains key, then, for companies to stay on top of what issues are of most concern to their investors and broader stakeholders. And until securities exchange commissions like the SEC specify ESG disclosures in their financial reporting requirements, the materiality of ESG topics will continue to be up to each company individually to determine, using GRI, SASB and others for guidance.

Or, in the words of Shakespeare, when it comes to determining the materiality of ESG topics, “to thy own self be true.”
Citations


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