Best practice III Data-driven materiality analysis

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A materiality assessment is a systematic analysis of societal needs and expectations, enabling the identification by a company of those issues that are crucial for both internal and external stakeholders, as well as gaps between business and society priorities. In this sense, a materiality analysis is a strategic compass informing Responsible Research and Innovation (RRI) assessments, ensuring that there is clear evidence that RRI efforts are oriented towards relevant and impactful (material) issues.

As of today, key stakeholders, regulators and investors are placing an increasing weight on the topic of materiality. This increased attention is causing a shift in practices around materiality, as a number of key debates and policy initiatives that are currently under way show.

One key example comes from the World Federation of Exchanges (WFE). In its *ESG Guidance and Metrics* (June 2018), the WFE includes a section on materiality, stating that investors wish to understand how companies determine which issues are material (process, timeframe, relevant legal framework, etc.).

Another major development comes from the European Union Commission, which is currently reviewing the Non-Financial Reporting Directive. As part of this update, the Commission has introduced a new definition of materiality (the *double materiality*) while asking for more disclosures on the materiality determination process, with particular reference to the methodology chosen.

Finally, in September 2019 the US Financial Services Committee voted to pass the ESG Disclosure Simplification Act, which will require public companies to disclose information on their environmental, social and corporate governance (ESG) practices, including a description of any process used to determine the impact of ESG metrics on the company's long-term business strategy. In this way, the Act recognizes officially that ESG metrics are material for the purpose of disclosure, so it is crucial to measure them in the most accurate way possible.

In light of all these policy developments, one question that organizations need to consider is: are the current materiality assessment processes

adequate? What characteristics should a robust materiality analysis feature?

Modern materiality needs to be *flexible*, *time-variant*, and *context-dependent*. Consequently, the only defence against subjective, manipulable and self-serving materiality is to ensure that the materiality assessment is accorded with a robust due process – and regularly updated, as emerging issues can rapidly change what is material.

Identifying and monitoring material risk and opportunities are key to business strategy. An inadequate or uninformed assessment approach exposes entities to reputational and legal risks, and this risk is extended along the whole value chain. However, the standards with which companies are required to comply are increasing exponentially, and while frameworks and regulations are asking for a robust process, they do it without describing how such a process should be structured.

The lack of a definition of what a robust materiality process is leads to an even deeper limitation of current materiality assessments, being that the purpose of the analysis is predominantly restricted to reporting only. Currently, sustainability and communications teams are in charge of the materiality and reporting processes – with little or no involvement from other key departments, such as strategy, governance and risk management (Calace, in press). As indicated by Eccles and Krzus (2014), in implementing materiality analyses, companies are expected to choose the issues that are most material in terms of their sustainability implications and then act accordingly. If an issue is identified as material, it should be included and explained broadly in the sustainability report and in the company's allocation of resources and efforts (Khan et al., 2016). In other words, a materiality assessment should go beyond the sole purpose of identifying issues that should be included in the non-financial report.

Scholars and experts are calling for the evolution of quantitative methods in materiality decision making (Calabrese et al., 2015; Edgley et al., 2015), currently relying mostly on anecdotal evidence from stakeholder workshops and roundtables, or from surveys. This broadening of the purpose becomes particularly important in light of the recent development of materiality analysis as the input for risk management processes (World Business Council for Sustainable Development (WBCSD) and Committee of Sponsoring Organizations of the Treadway Commission (COSO), 2018).

Such a debate around the materiality process leads by default to the question of how often companies should perform a materiality assessment.

All evidence leads to the fact that companies should carry out a continuous data-driven materiality analysis, no longer confined in the reporting area but thoroughly embedded in risk management processes. Even more: under every aspect, materiality is in its own essence a risk management process. The report is a simple outcome of this process. The sooner an organization

understands this, the sooner it will be able to future-proof its strategy and stay ahead of the competition.

In light of these considerations, the contribution of a data-driven and continuous materiality determination process to RRI appears crucial: without a credible materiality assessment as foundation, it would be difficult to assess to what extent an RRI initiative is an ancillary pet project or truly integrated in the business' core strategy.

Aims and goals

There are vast amounts of unstructured data publicly available representing what matters to stakeholders, and quantifying is crucial to achieve a robust materiality. Datamaran's approach leverages Natural Language Processing (NLP) to quantify narrative disclosures in annual financial reports, sustainability reports, Securities and Exchange Commission filings, mandatory and voluntary regulatory documents, social media and online news.

Benefit for organization

Using Datamaran's approach companies can stay in charge of their materiality and risk processes, identifying trends that are concealed in unstructured data (Datamaran, 2019). The insights gained will enable users to build a credible and auditable process to identify and monitor material issues, enabling them to focus on the implications of the issues identified and strategize leveraging a data-driven approach.

References

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