Corporate Sustainability Factors and Influencers Explained

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Who's Involved and What's Critical to Know about this Emerging Field of Corporate Strategy

The sustainability reporting marketplace has long been an "alphabet soup" of acronyms, organizations, and datasets that shape and define disclosure practices and transparency principles. Because of a lack of consistent, global regulation, the number of influential stakeholders for sustainability reporting is often more expansive than that of financial reporting. Along with this, the wide audience and range of topics that sustainability reporting seeks to address can confuse companies on what to prioritize. In short, sustainability reporting can be difficult to unpack for investors and practitioners. At Morningstar, we recognize the need for a clear analysis of the influential principles, stakeholders, frameworks, standards, and processes that contribute to sustainability reporting.

In this report, we examine concepts critical to reporting, including materiality, reporting frameworks and standards, ESG ratings firms, and emerging international partnerships that are organized (or are organizing) around principles of sustainability. Our purpose is to provide readers with a reference guide for understanding sustainability reports, deepen individual investors' understanding of the space, and provide stakeholders with a survey of the evolving reporting landscape.

Introduction to Materiality

In the context of sustainability reporting, materiality refers to the financial significance of key measures and events and their relevance to the long-term success of a company or organization. Material issues for an organization are understood to influence the financial health of a firm. When we look at materiality with a corporate sustainability lens, we examine the sustainability areas that may pose a significant risk or opportunity to the success of a company or industry. These material topics differ depending on sector, business operations, geography, and size of the business, to name a few.

Increasingly, firms prioritize the determination of material ESG issues (MEIs) in order to shape strategy, management approaches, and disclosure in reporting. In many cases, companies and organizations reference an "expert" analyst lens in this process. This may include examining sustainability framework providers and ESG research firms to determine the issues most likely to have a significant impact on the business. These market segments are detailed later in this document.

Double Materiality

The concept of double materiality comes into play when disclosure topics are both financially material to enterprise value and important to stakeholder desires. This idea draws on the emerging understanding that a company's value and impact go beyond profit generation and can span more broadly to the environment, people, and the marketplace. This additional lens, to supplement the expert details that measure business impact (mentioned above), provides insights into what a firm's stakeholders would like to see prioritized by the business, but these topics may not have an immediate impact to the business' bottom line. For example, experts in the sustainability field might not examine "diversity in the supply chain" as a topical area that, if not invested in, would hurt a financial service company's bottom line immediately. However, if employees, clients, and community members are seeking more insight into a company's data on diverse suppliers, then this topic may be prioritized to meet the desires of these audiences.

Double materiality can also affect investor decisions. In the United States, the Securities and Exchange Commission has not yet introduced double materiality regulations, but the European Union has already put some of these factors into play. Firm disclosure of sustainability-related information will increasingly play a role in investor decisions.

For Practitioners: Defining Materiality

For a company that is interested in beginning its corporate sustainability journey, one of the first steps should be conducting a materiality assessment. A materiality assessment is the process of identifying, refining, and assessing the various potential environmental, social, and governance issues that could affect an organization. These topics can affect a firm's bottom line, recruitment efforts, attractiveness to investors, and the overall health of a business. These areas should be outlined as potential opportunity areas and risk areas, depending on the firm's mission. There is currently no standardized process for defining material ESG topics, but there are a few key considerations that a business should assess. Key areas to consider in materiality examinations are explored on the following page.

Firm disclosure of sustainability-related information will increasingly play a role in investor decisions.

Business Impact Lens

Research and ESG Risk Ratings Providers

Ratings agencies such as Morningstar Sustainalytics, MSCI, and Institutional Shareholder Services (ISS), amongst other firms, already have methodologies in place to determine how they rate individual company's E, S, and G efforts. The material ESG topics analyzed by these ratings organizations can be used to understand what topics analysts consider material to a business.

Framework Alignment

Industry-specific reporting frameworks, such as standards from the Sustainability Accounting Standards Board, provide specific issue areas that they consider material by industry. These industry- specific material topics can be used as a guide in a materiality assessment. View SASB's Materiality Finder **here**. More details on framework and standards providers can be seen on page 7 below.

Stakeholder Lens

Internal Stakeholder Feedback

What better way to inform corporate strategy than going to those who have the most direct impact on a business? Consulting with a firm's own employees and board of directors is critical in understanding what sustainability topics are important to a firm's stakeholders. In order to increase engagement related to sustainability initiatives, it is important that key internal stakeholders also have a say in which areas should be prioritized. This research can be collected in the form of surveys or interviews.

External Stakeholder Feedback

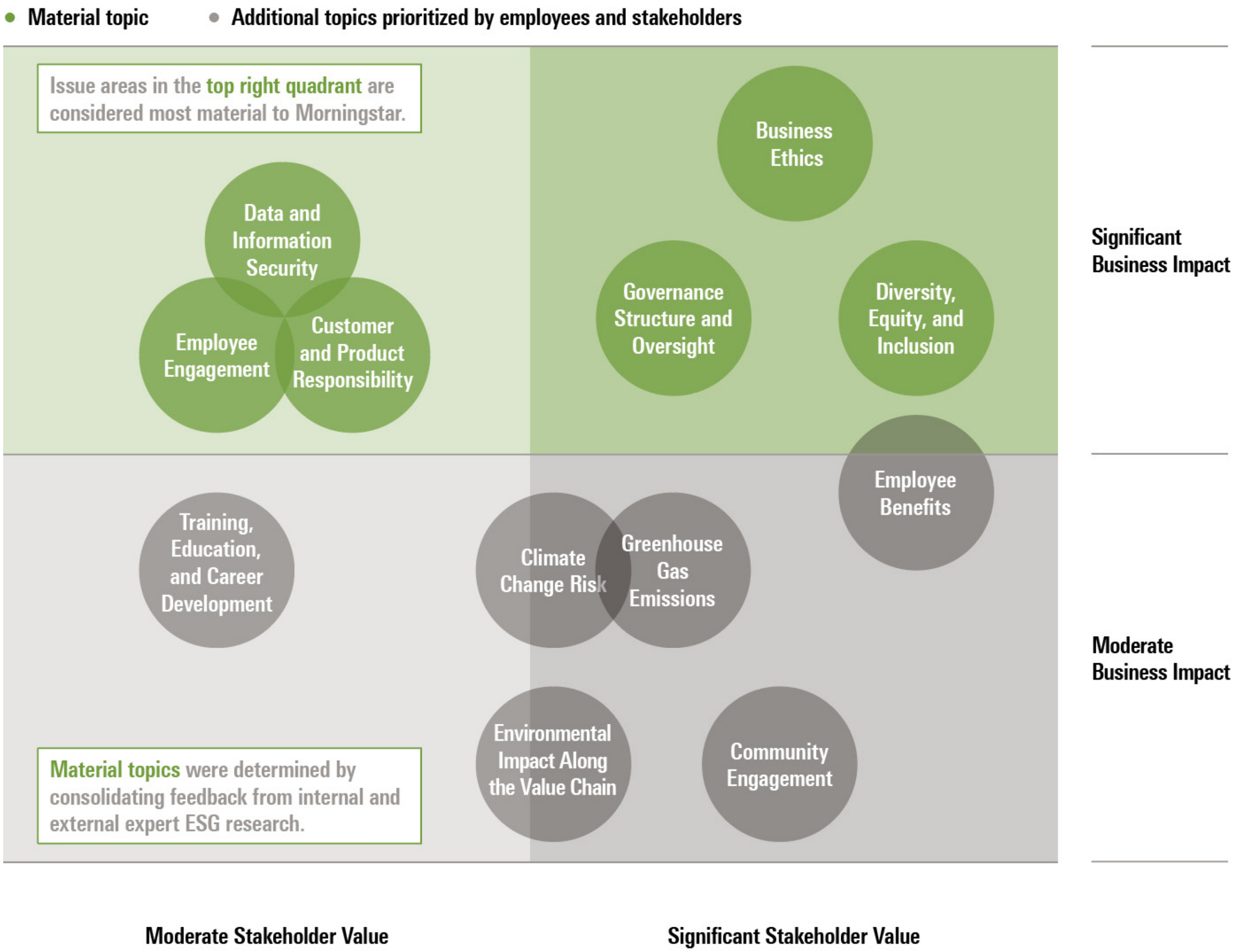
Like internal stakeholder opinion, it is also important to consider the viewpoint of external stakeholder groups, such as shareholders or customers. This information can be collected by conducting surveys, interviews, or examining inbound requests for proposals, or due diligence questionnaires. Additionally, by examining institutional investors' engagement plans or stewardship policies, one can understand the sustainability topics examined by the institutional asset owner when making investment decisions.

Once a business has defined material topics, these areas can be used to guide company strategy, forward-looking goals, disclosures, and reporting. See page 6 for an example of how Morningstar visualizes it's determined double materiality.

As a business evolves and grows, material topic areas may not stay constant as societal expectations and risk and opportunity areas shift. Because of this, it is recommended to review a materiality assessment every few years. This is also important because the corporate sustainability regulatory landscape is rapidly evolving. Increased regulations relating to ESG reporting, such as the U.S. SEC's Climate Disclosure Proposal, will have an impact on corporate sustainability materiality, as well as changes in ESG rating methodologies.

The below visual (page 6) represents Morningstar's understanding of their current material ESG issues (MEIs). Morningstar visualizes their double materiality framework by plotting the MEIs on an axis that shows severity of business impact vs. stakeholder value.

Morningstar's Materiality Matrix



Organization Influence on Sustainability Disclosure

Introduction

There are many types of organizations that serve as inputs to corporate sustainability strategy, management, and reporting. Each of these organizations has influence over the disclosure landscape. Commonly managed by nongovernmental organizations or nonprofits, sustainability coalitions unite companies of similar or differing industries to work toward common sustainability outcomes. These agreements provide reinforcement and produce comparable frameworks for data disclosure and progress updates. Ratings providers also influence reporting by providing graded feedback to firms on their sustainability work. See more on sustainability frameworks and standards providers, ESG ratings firms, and sustainability partnerships and initiatives below.

Framework and Standard-Setting Providers

Over the past few decades, framework and standards providers have maintained a view on issues that corporates should consider for disclosure. These organizations allow companies to disclose sustainability information in a way that is comparable to others in the industry and most relevant to the company's specific operations. We like to think of these organizations as filling a hole made by the regulatory market. For example, if the SEC explicitly told companies what sustainability information to disclose and how to disclose it, then we would need less disclosure guidance set forth by these organizations. These frameworks and standards allow for stakeholders to access decision-useful data and information that can be compared with other companies that are also reporting under the same framework or standard. See more details on these organizations below.

"These organizations allow companies to disclose sustainability information in a way that is comparable to others in the industry and most relevant to the company's specific operations."

Frameworks vs. Standards

One of the most common areas of confusion in sustainability reporting is the distinction between the characteristics of what makes a sustainability framework vs. a sustainability standard in the marketplace.

At a high- level, sustainability frameworks help reporting issuer's structure and prepare topical areas for disclosure. This implements consistency in how information is disclosed across organizations. Frameworks focus primarily on a principles-based approach to disclosure, as they provide information on what companies should consider in their reporting practices but do not necessarily prescribe the exact data or information to disclose.

Sustainability standards determine specific data and information that firms should disclose publicly, but they do not necessarily inform companies on how to format the presentation of the information. Standards providers focus on detailing the exact data to be reported to make it comparable across firms (typically in the same industry, more on this below). This is more analogous to accounting and line-item reporting, where the data expected to be disclosed by each audience is understood.

These two examples provide a helpful way to distinguish the differences between sustainability frameworks and standards:

- SASB Standards prescribe, by subindustry, what data companies should disclose based on the inherent risks the industry is exposed to. These standards prescribe exactly the quantitative and qualitative information companies should disclose to say they align with SASB Standards. But these reports can look different in nature, with expectations on how to format the reports not prescribed by SASB.

- On the opposite end, the Task Force for Climate-Related Financial Disclosures is a principles-based framework that focuses on detailing what companies should consider when disclosing risk and opportunities related to the transition to a low-carbon economy. This provides the topical areas for consideration and how to disclose this across firms in all sectors. This allows a company to adopt the areas of disclosure that most fit its business, disclosing the details in a consistent format with similar considerations accounted for but with exact measures of disclosure up to the reporting company to determine[1].

	SASB	TCFD
Scope of Information	Environmental, social, & operational governance	Climate
Type of Guidance	Standards	Framework
Industry-Agnostic or Industry-Specific	Industry-specific	Industry-agnostic & industry supplements

[1]TCFD details that reporting firms should disclose their Scope 1 - 3 greenhouse gas emissions
[2]Source: Fundamentals of Sustainability Accounting (FSA) Credential, Sustainability Accounting Standards Board

In addition to the distinction between frameworks and standards, these organizations also differ in a few ways. First, the topical areas disclosed differ across frameworks and standards. For example, CDP and TCFD focus disclosure on a firm's environmental impact, while SASB and Global Reporting Initiative outline disclosure for topics across the environmental, social, and governance spectrum.

Additionally, these organizations have different audiences for their disclosure, which changes the scope of what is included. Naturally, employees of a company may seek different areas of disclosure than shareholders, so understanding the focused audiences of each framework or standard can help determine where to align. For example, SASB is focused on disclosure for providers of capital, which means that its disclosure standards are focused on areas that may lead to enterprise value creation and risk reduction. GRI's target audience includes all stakeholders, which is why its disclosure standards extend beyond just the immediate areas of risk for a company and out to initiatives that employees, communities, and clients may care about.

Finally, standards and frameworks vary based on whether they are industry-agnostic or industry-centric. Frameworks, like SASB, provide guidance based on the subindustry in which a company operates. This is because the risk considerations vary based on the industries in which companies operate. TCFD applies the same principles-based framework to all companies, regardless of industry.

The Fundamentals of Sustainability Accounting Credential program outlines the distinction between the most common frameworks and standards in the marketplace in a clear format. These details can be seen in Appendix 1.

ESG Rating Firms

Another major factor in sustainability reporting and strategy is the influence of ESG ratings providers. Often, these are confused with framework and standards-setting organizations because of their similarities in having research analysts who outline the areas of ESG focus for firms. They also have a large impact on a firm's materiality, given their expert guidance in analyzing topics to prioritize.

ESG ratings providers develop methodologies to score or rank a company based on the publicly available information on a firm's sustainability position. The major players in this market include Sustainalytics Morningstar, MSCI, ISS, FTSE Russell, S&P Global, Bloomberg, and Moody's. Each player in the market has a unique methodology, but universally, the space recognizes an industry-centric approach to rating companies on their sustainability practices. This means that most firms recognize that it is not logical to compare the sustainability practices of an oil and gas company with a financial-services company, for example. The major areas of differentiation between firm methodologies include the sustainability topics considered material to the firm or industry and how much weight is applied to each issue area. Some ratings providers place more emphasis on the importance of corporate governance, while others look at environmental initiatives across industries. Clients of ESG ratings providers either seek the methodologies they most align with, or— in many cases— users will purchase ratings and data from multiple competitors to find commonalities to utilize in their decision making.

ESG ratings providers primarily serve the financial-services market, informing on which companies do best or worst in ESG management. This helps finance companies build sustainable funds, create sustainable indexes, or limit investment involvement in companies with controversial or risky sustainability practices. But naturally these third-party ratings providers are also a major driver for issuers seeking to enact sustainable programs and practices.

> These ratings often provide a starting place for determining material topics of focus, and the ratings systems allow issuers to measure progress and work toward best practices.

Sustainability Partnerships and Initiatives

Firms may also select to partner with or become a member of sustainability agreements. These agreements range in topic and commitment level but typically work to unite companies or common entities that are focused on solving similar sustainability issues. These partnership organizations are typically managed by NGOs, nonprofits, or private companies, such as the United Nations or the International Financial Reporting Standards. These organizations build sustainability agreements and initiatives that reinforce the need for progress updates, transparency, and alignment. They allow companies to engage in thought leadership opportunities and provide a mechanism for companies to showcase their commitment to sustainability work.

As there is currently little regulation in the corporate sustainability space, these agreements make it easier for companies to align with preset goals and track their progress toward a common outcome. Some agreements are more impact-specific, such as those concentrated on climate-impact, while others focus on the investor lens. The **U.N. Global Compact** is currently the world's largest corporate sustainability initiative. Members of the compact agree to aligning their operations with its 10 Principles focused on human rights, labor, environment, and anticorruption. They also must take strategic action to advance broader global goals, such as the **U.N. Sustainable Development Goals.** Companies that take part in the compact must report on their sustainability progress annually with a submission of a Communication on Progress, requiring them to respond to reporting disclosure on their website in order to remain a member.

Companies and organizations are also increasingly aligning with public climate commitments. Most frequently, these commitments are organized beneath industry-specific "net zero" coalitions, where member firms commit to decarbonization. "Net zero" refers to the balance between the amount of greenhouse gas produced and the amount removed from the atmosphere. Specific net-zero alliances can follow criteria set by outside organizations like the **Science-Based Targets** initiative, which provides companies with a clearly defined path to reduce emissions in line with the Paris Agreement goals, or the U.N. Race to Zero criteria. Alliances can also require industry-specific decarbonization actions.

There are also some partnerships that focus on specific industries, meaning that their targets, reporting requirements as a member, and outcomes are focused on areas specific to that industry. For example, the **U.N.-backed Principles for Responsible Investing** encourages investors to use responsible investment to enhance their returns and manage ESG risk. This organization is governed by Six Principles for Responsible Investment, which firms can utilize to disclose and champion ESG issues at every level of their businesses. Members of the UNPRI must report on their work annually.

Conclusion

We hope corporate issuers that are starting or in the middle of implementing their ESG strategies can utilize this report as a tool. This report details the groups of stakeholders and institutions that affect the sustainability landscape. Companies that examine the sustainability expectations of these groups —for their sector or organization —are better able to structure their businesses to empower stakeholders.

Likewise, we hope investors or external stakeholders who are interested in understanding a firm's ESG strategy or sustainability risk management approach can use this report can provide context when analyzing a corporation's sustainability report or understanding the inputs to ESG risk ratings.

As the industry evolves, these standards and frameworks will continue to align more closely until there is better standardization and comparability of ESG data within the marketplace. Until then, individual organizations are paving the way in determining what ESG areas should be prioritized, how companies should manage these topical areas, and how the data outputs of these topics should be reported.

Appendix 1*

	CDP	CDSB	GRI	IIRC	SASB	TCFD
Scope of Information	Environmental	Environmental	Environmental, social, operational governance, & economic	Environmental, social, economic, for physical & knowledge-based assets	Environmental, social, & operational governance	Climate
Type of Guidance	De facto standards	Framework	Standards	Framework	Standards	Framework
Industry-Agnostic or Industry-Specific	Industry-agnostic & industry supplements	Industry-agnostic	Industry-agnostic & emerging industry-specific	Industry-agnostic	Industry-specific	Industry-agnostic &industry supplements
Target Audience	All stake-holders	Providers of capital	All stake-holders	Providers of capital	Providers of capital	Providers of capital
Approach to Materiality	Significant impacts on the economy, environment, & people	Enterprise value creation	Significant impacts on the economy, environment, & people	Enterprise value creation	Enterprise value creation	Enterprise value creation
Time Horizon	Short-, medium-, & long-term	Short-, medium-, & long-term	Short-, medium-, & long-term	Short-, medium-, & long-term	Short-, medium-, & long-term	Short-, medium-, & long-term
Governance Model	—	—	—	—	—	—
Governance Documents		x	x	x	x	
Public Meetings			x		x	
Public Comment		x	x	x	x	x

*Source: Fundamentals of Sustainability Accounting (FSA) Credential, Sustainability Accounting Standards Board