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Towards the use of Balanced Scorecards to Determine Materiality

Kazunori Ito

Professor of commerce, Senshu University, Japan

Introduction

The International Integrated Reporting Committee (IIRC) published the IIRC Framework in 2013. Although the Framework was slightly revised in 2021, it still fundamentally adheres to the original version. However, the IIRC framework is not without its problems. For example, it is unclear what distinguishes integrated thinking and information connectivity, how best to visualize the value creation process, etc. Similarly, what the IIRC Framework means by “materiality” is not always crystal clear. Certainly, the Framework does indicate the processes for determining materiality, but concrete ways of specifying materiality are still unclear.

Enterprise value and developments in the concept of “sustainability”

Recent years have seen a shift in corporate purpose—from its emphasis on shareholders to stakeholders. It has thus become common to consider both shareholder and stakeholder values.

These kinds of changes in governance are one reason why sustainability is now emphasized. The concept of “sustainability” has dramatically changed since it was first proposed. Initially, the term meant the creation of economies that would be able to preserve the Earth forever. Various problems arose that could eventually make our planet uninhabitable: environmental pollution resulting from market economies, population increases in poor countries (“survival” economics), and the depletion of renewable resources (economies of nature). Thus, “sustainability” meant decreasing the environmental burdens of business activities and eliminating waste and depletion activities.

Thereafter, sustainability came to indicate proactive engagements by companies to resolve environmental burdens. Here, strategies were implemented that impacted a company’s competitiveness. This resulted in cutting costs as a means of reducing environmental loads while simultaneously realizing environment-related innovations. It was determined, however, that desirable effects could not be realized solely by companies working alone on environmental issues. Here, environmental engagements along the entire supply chain became an issue of key importance.

This is where the idea of sustainability halted and became fixed. It was now the awareness that environmental engagement was necessary throughout the supply chain. However, what happens to the concept of “sustainability” when viewed in its relationship with enterprise value?

Economic value and social value

In the IIRC framework, two kinds of value can be created: value for one’s company and for others. Here, value creation for one’s own company via strategies becomes the strategic creation of economic value. Opposed to this is value creation for other companies, which is value creation for stakeholders. Stakeholder value comprises various kinds of value, including customer value, social (societal) value, and organizational value. The term “social value” is used here to indicate all said values.

“Enterprise value” can arise from both the creation of economic value via business strategies and the creation of social value via the solution of social (societal) issues. Value creation due to business strategy is value creation for one’s firm, and value creation for others results from resolving social issues. Meanwhile, value creation via business strategies and value creation involving social issues cannot be seen as distinctively different value creation. Let us consider this point in more detail.

Value creation via business strategies is the pursuit of economic value. Consider, for example, issues that are unrelated to solving social problems. One example of such economic value pursuit is product development resulting from the excavation of latent customer needs. There is also the case of "scrapping and building" of companies and business divisions, performed in consideration of synergistic creation and portfolio management.

Meanwhile, there is the case where business strategies are used to resolve a social problem. This is both the pursuit of economic value and the pursuit of social value. Porter and Kramer call this creating shared value (CSV).Examples of CSV include product development for environmental burden reduction and product creation that eliminates or reduces the amount of needed rare earth elements. Sustainability management aims to discover and solve issues in this domain.

There are also social issues that, while unrelated to the business itself, are management issues. Examples are risk management, compliance, and other activities not involved with value creation via business strategies. In fact, these may involve no value creation whatsoever. Risk management, compliance, etc., are activities for reducing reputation risks and, like the reduction of environmental burdens, aim to prevent value loss or erosion.

In sum, when economic value can be pursued via strategy, whether for one's own company or for others, they can all be called "value creation."Conversely, a company must not only pursue value creation, but it also needs activities that restrict value erosion. From the above, the distinction made in the IIRC that classifies something as "for one's own company" or "for others" does not always indicate that one is striving to prevent value erosion. We thus propose the need for a distinction between the classifications "value creation" and "prevention (restraint, etc.) of value erosion."

IIRC and materiality

In the IIRC Framework, "materiality" is defined as the disclosure of information on management issues that substantially affect short, middle, and long-term value creation. Both positive and negative business issues are applicable to the process of determining materiality, including risks and opportunities, desirable and undesirable business results, and prospects. Further, not only is financial information applicable, but also non-financial information.

One process for such determinations involves the use of the matric introduced in the IIRC draft of 2013. Here, the matrix comprises the possibility of phenomena occurring and the extent of their effects on one's company. Using this matrix, "materiality" is when there is a high possibility of a certain phenomenon occurring and where said occurrence will have a major (high) impact on one's company.

Meanwhile, a survey of integrated reports by Japanese companies shows that, in many cases, the Global Reporting Initiative (GRI) is referenced. The GRI uses a matrix comprised of impact on stakeholders and impact on one's company. Using this matrix, most cases of "materiality" involve management issues that will strongly impact both stakeholders and one's company.

Balanced scorecards and materiality

In addition to the materiality determination processes of IIRC and GRI, we would like to propose one other possibility, that of the balanced scorecard (BSC).We feel that there are many cases worldwide where a BSC is introduced by companies when creating integrated reports. We thus propose a materiality determination process using a BSC.

A scorecard is used to create a strategy map that makes strategy visible and to measure and manage (control) the goals for each strategy. While strategy maps are a tool for visualizing strategy, there is no reason why such maps cannot be used to make materiality visible. First, a division is made between strategy maps involving value creation and strategy maps involving the prevention of value erosion.

Strategy maps for value creation are those that have been used hitherto to make strategy visible by showing the cause-and-effect relationships among strategy goals and targets. Meanwhile, a strategy map for preventing value erosion involves strategy goals like risk management and compliance from the perspective of internal business processes. These can be linked with strategy goals involving customer perspectives, including improving corporate reputation and reducing reputation risks. While these kinds of strategic goals may be negative in the short term in terms of financial results, they do support financial results over the long term.

"Materiality" indicates activities or activity programs. Meanwhile, the goals shown in strategy maps are not for activities but to make visible cause-and-effect relationships among strategy goals. So, how are activities shown in BSCs? Here, strategic initiatives are activities. That is, "strategic initiatives" are key management issues necessary for the realization of strategies. Strategic initiatives shown on the scorecard can be used to determine materiality through the creation of strategy maps whereby a BSC is introduced and where strategies themes are value creation and the prevention of value loss. In this way, BSCs can be used to introduce strategies and social-issue management issues without considering materiality.

Summary Conclusion

For many companies, the process of determining materiality involves the creation of a matrix according to the GRI. There, "materiality" is materiality for social issues. However, management issues involve more than the indication of social issues in that business strategy is also a management issue. It may be that simply following GRI may result in a lack of consideration of management issues as strategies.

For this, companies that introduce a BSC divide strategy issues into value creation and preventing value loss and make strategy maps accordingly. Using the scorecard only to measure and manage (control) strategies will enable rational and automatic materiality decisions by using the strategic initiatives that arise from this scorecard usage. Thus, we propose that materiality decisions should involve more than social issues alone; they should also involve strategy and social (societal) issues simultaneously.

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