ISEG Lisbon School of Economics & Management Universidade de Lisboa

Master in Management
FINANCIAL
AND
ESG REPORTING
Class 3

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Financial and ESG Reporting

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Group work:

Deadline: 11:59 PM (Lisbon time) on Friday, 18th October 2024

A sample group work

Any questions?

Financial and ESG Reporting

Objective of this class:

Sustainability and sustainability reporting

Sustainability reporting frameworks

European sustainability reporting standards (ESRSs)

Financial and ESG Reporting

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Reading:

Main reading:

Rankin, M., Ferlauto, K., McGowan, S., & Stanton, P., 2022. *Contemporary Issues in Accounting*. 3rd ed. Australia: Cengage. ISBN 978-0-730-39782-3.

- Chapter 10

Supplementary reading:

Christensen, H. B., Hail, L., & Leuz, C. (2021). Mandatory CSR and sustainability reporting: Economic analysis and literature review. *Review of accounting studies*, *26*(3), 1176-1248.

Sustainability and sustainability reporting

From profitability toward sustainability

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- From a reductionist focus on profit, toward a holistic perspective and a balance between economic, social and ecological aspects of company's business accountability.

- **Business sustainability** is often defined as the triple bottom line management, a process in which companies manage their **financial**, **social**, and **environmental** risks, threats and opportunities. These three impacts are often called "Profit, People, and the Planet" or **3P** (Elkington, 1994).

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What is sustainability?

- **Sustainable development:**
  - ‘development that meets the needs of the present without compromising the ability of future generations to meet their own needs’.
  - This definition relates to three main areas:
    - economic development
    - environmental development and
    - social development.

Similar terms

- Sustainability: emphasizes the long-term horizon
- Environmental, social and governance (ESG): explicitly incorporates governance factors, often covering a wider scope
- Corporate social responsibility (CSR): tends to be defined slightly more broadly and normatively
- Environmental reporting, triple bottom line reporting, stakeholder reports…

Sustainability reporting

- A **sustainability report:**
  - presents information about the economic value of an entity, and
  - information upon which stakeholders can judge the environmental and social value of an entity.

- Sustainability reports are presented by a large range of organisations from most sectors, including not-for-profit entities and the government sector.

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Sustainability reporting

"Sustainability reporting helps organizations to set goals, measure performance, and manage change in order to make their operations more sustainable. A sustainability report conveys disclosures on an organization's impacts – be they positive or negative – on the environment, society and the economy. In doing so, sustainability reporting makes abstract issues tangible and concrete, thereby assisting in understanding and managing the effects of sustainability developments on the organization's activities and strategy."

-- Global Reporting Initiative (GRI 2015, p. 3)

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Sustainability reporting

"…we refer to CSR and sustainability reporting as the measurement, disclosure, and communication of information about CSR or ESG topics, activities, risks, and policies..."

-- Christensen *et al.*, 2021, RAST

Characteristics of sustainability reporting

Compare to traditional financial reporting…

- Diversity of users and uses
- Diversity of topics
- Diversity of objective functions
- Diversity in measurement
- Voluntary nature of CSR activities
- Long-term horizon
- Central role of externalities

Why to develop a ESG Report?

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Financial reporting is not enough!

- They do not reflect the entire business activity of a company.
- Reflects only short-term monetary aspects of business, but does not provide insight into environmental, social, and managerial aspects of business, which are, in the long term, much more important.
- Nonfinancial reporting is a ‘must’ in the modern economy as it reflects the responsibility of a company to conduct business activities in a sustainable way.
- This helps investors, consumers, policy makers and other stakeholders to evaluate the **non-financial performance** of large companies and encourages these companies to develop a responsible approach to business

Sustainability reporting

- **Benefits:**
  - Embedding sound corporate governance and ethics systems throughout all levels of an organisation.
  - Improved management of risk through enhanced management systems and performance monitoring.
  - Formalising and enhancing communication with key stakeholders such as the finance sector, suppliers, community and customers.

Sustainability reporting

- **Benefits:**
  - Attracting and retaining competent staff by demonstrating an organisation is focused on values and its long-term existence.
  - Ability to benchmark performance both within industries and across industries.

Why to develop a ESG Report?

1. provides companies with a means to show their stakeholders, and society in general, that they consider their expectations and operate within the bounds of the social contract.

2. companies might join sustainability indices (Dow Jones Sustainability Index or Footsie4Good…)

3. It is also an internal management tool to affirm that the company is on track with its commitments.

4. more and more external bodies are demanding integrated reports that contain not just financial and economic information but societal and environmental data too.

Why to develop a ESG Report?

INTERNAL BENEFITS

- Vision & Strategy

Organizations can set direction by placing their purpose, vision and strategy into the context of global sustainability. The sustainability reporting process helps to make this explicit to stakeholders.

- Management Systems

Sustainability management and reporting requires management systems, which improve data quality. Tracking data highlights opportunities for improvement, efficiency and cost savings.

- Strengths & Weakness

Early warnings of emerging issues can help management seize opportunities or evaluate potentially damaging developments early, before they emerge as unwelcome surprises.

- Employee Motivation

Engaging the workforce in sustainability efforts reduces absenteeism, attracts new talent and increases productivity through a motivated workforce. It is also a great way to upscale efforts.

Why to develop a ESG Report?

EXTERNAL BENEFITS

- Reputation & Trust

Proactive and transparent communication about your sustainability efforts builds goodwill, reducing reputation risks. It also improves product image, brand name and reputation.

- Attracting Capital

Reducing risk through sustainability management and communication can help signal quality and good management, providing potential for new sources of capital and lower costs.

- Stakeholder Engagement

Ongoing learning from the outside-in. Stay up-to-date on the regulatory environment. Sustainability reporting is a powerful tool to build or restore trust among stakeholders.

- Competitive Advantage

Customers are looking for suppliers that minimize environmental and social risks. By reporting, one can increase customer satisfaction and loyalty, and access the supply chain.

Determinants of ESG disclosure-Research evidence (Christensen et al., 2021)

❑Generic firm and manager characteristics

- Firm size:
  - Greater public scrutiny, which incentivizes larger firms to engage in CSR activities and reporting
  - Less costly for larger firms

- Ownership structure:
  - Dispersed private-sector ownership (+), concentrated ownership (-), foreign ownership (+)
  - CSR reporting is more prevalent when information asymmetry is high or when firms need to communicate with a larger set of shareholders

Determinants of ESG disclosure-Research evidence (Christensen et al., 2021)

❑Generic firm and manager characteristics

- Corporate governance:
- Robust corporate governance mechanism (long-term incentives schemes, number of board meetings) (+), stakeholder orientation in corporate governance policies (+)

- Managerial characteristics:
- Educational levels and training (MBA + vs. law degree -)
- Compensation (+)
- Career concerns (+) and power (-)
- Whether the CEO has a daughter
- CEO fixed effects explain 59% of the variation in CSR scores, whereas firm fixed effects only explain 23%

Determinants of ESG disclosure-Research evidence (Christensen et al., 2021)

❑Firms' economic activities

- Sin and polluting industries (+)
- CSR performance (+/-)

❑External stakeholder and societal pressure

- Institutional investor
- Government and policymakers
- NGOs, customers, employees…

The different types of report

- **Stand-alone reports** that focus on social and environmental issues
- **Combined reports** that introduce social and environmental issues into the existing financial annual report
- **Integrated reports** that highlight linkages across financial and non-financial information

Integrated reporting

- **Integrated reporting** is a recent initiative designed to improve sustainability reporting and integrate it more closely with financial and governance reporting

- The development of integrated reporting followed the global financial crisis and resulted from a perceived need for a new economic model to protect a range of stakeholders from subsequent crises

- Governments and business leaders recognise that there needs to be a change in the emphasis of corporate reporting, given it currently does not adequately reflect *material environmental, social, and governance factors, such as resource usage, social impacts, human rights and how businesses may contribute to climate change*

Integrated reporting

What is Integrated Reporting?

' A concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term.'

Paul Druckman, CEO of IIRC, 2013

HOW VALUE IS CREATED?
Communicate the full range of factors that materially affect value

The International Integrated Reporting Council (IIRC) defines an integrated report as one that 'brings together material information about an organization's strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operate

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Integrated reporting

Concise communication on how organizational strategy and management lead to value creation:

www.youtube.com/watch?v=EFm0sKeBLh0

https:/://www.youtube.com/watch?v=Hx4dvrIunpw

Integrated reporting framework

2010: the Prince of Wales' Accounting for Sustainability Project (A4S) and Global Reporting Initiative (GRI) formed the International Integrated Reporting Council (IIRC)

2013: the IIRC developed its International Integrated Reporting Framework, known as the International <IR> Framework

- requires information about organisations' strategies, governance, impacts, performance and prospects and aims to 'secure the adoption of integrated reporting by report preparers and gain the support of regulators and investors'

2021: <IR> Framework revision

- simplify the required statement of responsibility for the integrated report, improved insight into the quality and integrity of the reporting process and create a clearer distinction between outputs and outcomes

June 2021: IIRC merged with the Sustainability Accounting Standards Board (SASB) to form the Value Reporting Foundation (VRF)

Integrated reporting framework

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- Interrelates financial with non-financial reporting to provide an **integrative and comprehensive overview of the business** activities of a company, their results, and consequences for people and the environment.
- While sustainability reports and nonfinancial reports can be disclosed autonomously, an integrated report represents a **single report** that includes not only social and ecological but also economic aspects. In that sense, integrated reports are comprehensive, reflecting a **holistic perspective** on business activity.

Integrated reporting framework

What does the organization do and what are the circumstances under which it operates?

How does the organization's governance structure support its ability to create value in the short, medium and long term?

What is the organization's business model?

What are the specific risks and opportunities that affect the organization's ability to create value over the short, medium and long term, and how is the organization dealing with them?

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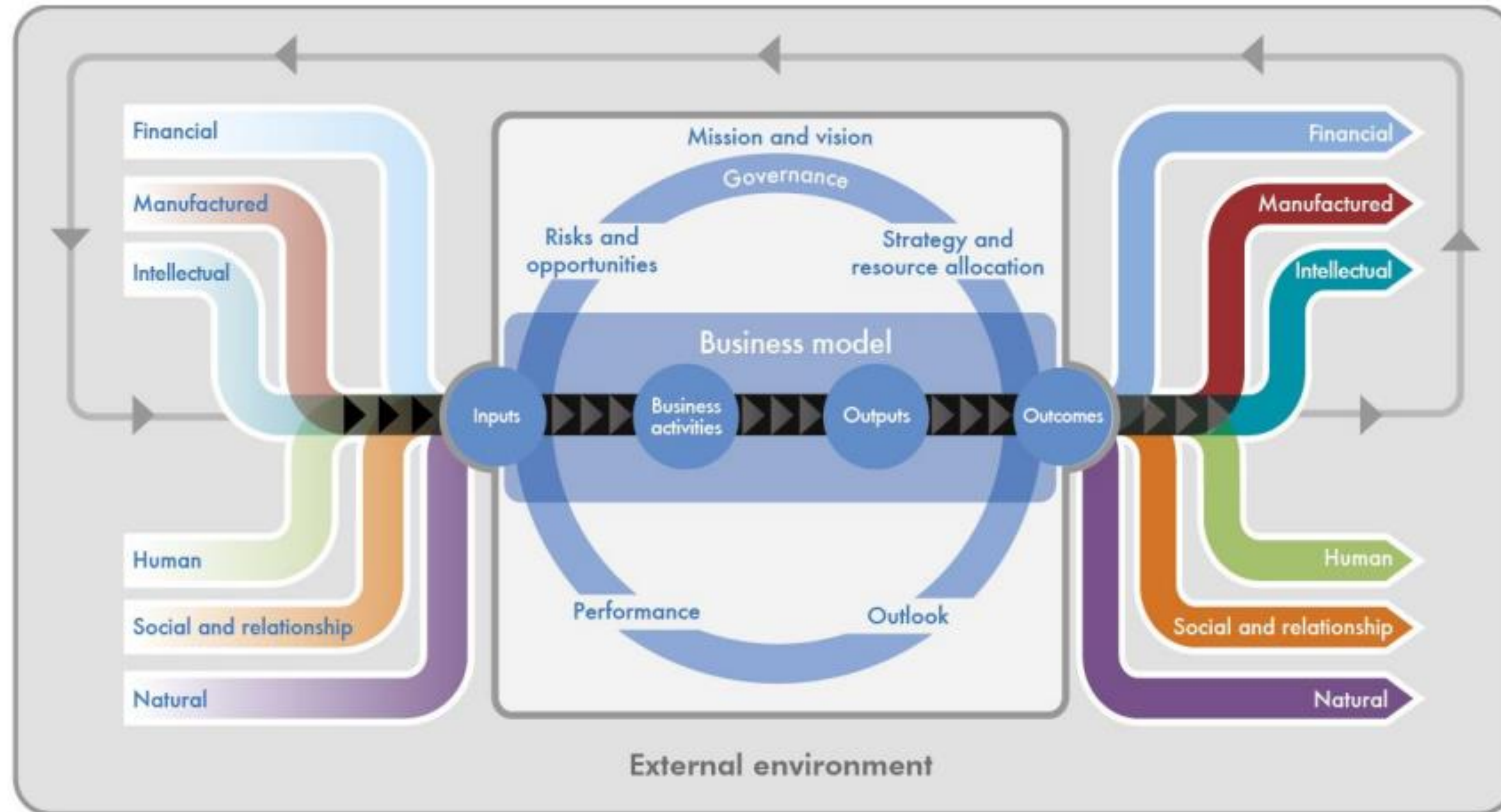
Integrated reporting should provide:



Holistic picture of dependencies between the factors that affect organization’s ability to create value over time.

Sustainability reporting frameworks

Sustainability reporting standard and framework

Why do we need sustainability reporting standards?

- Standards and frameworks are often advertised as an opportunity to get more **regularity, consistency and comparability** into the voluntary disclosures, but also with the claim to enhance the **materiality** of the disclosures. This implies that the standards and frameworks help organisations focus on the more important and relevant matters while leaving the less important issues with limited or no attention.

Sustainability reporting frameworks

- Most well-known global guidelines

  GRI, IIRC, SASB

- Some other specific frameworks

  CDP, TCFD

https://view.genial.ly/616cd3a3f1952d0dd5cd4c15/interactive-content-untitled-genially

Sustainability reporting standard and framework

	Global Reporting Initiative (GRI)	International Integrated Reporting Council <IR>	Sustainability Accounting Standards Board (SASB)
Founded	1997	2010	2011
Aim	To empower decisions that create social, environmental and economic benefits for everyone	Establish integrated reporting and thinking within mainstream business practice as the norm in the public and private sectors	Establish industry-specific disclosure standards across environmental, social, and governance topics that facilitate communication between companies and investors about financially material, decision-useful information
Main users for the report	Stakeholders at large	Mainly investors, but also others	Financial markets, investors
Key concepts	Materiality, accountability	Integrated thinking, value creation	Financial materiality, decision-usefulness, value relevance

Source: Tregidga and Laine (2021)

The Global Reporting Initiative (GRI)

The GRI is the **most used** reporting framework.

- "Today, more than two-thirds of the N100 use the GRI(68 percent) — although this is only a slight increase of1 percentage point from 2020. The corresponding figure for the G250 is 78 percent — an increase of5 percentage points in the past 2 years" (KPMG, 2022)
- N100: Worldwide sample of the top 100 companies by revenue in 58 countries, territories and jurisdictions
- G250:World's 250 largest companies by revenue based on the 2021 Fortune 500 ranking

The GRI guidelines have been rebranded in 2016 and are now called the GRI standards.

While in the early years, the GRI guidelines offered a list of indicators, now the standards prescribe more precisely how companies have to approach the reporting process.

Another important change is that the concept of materiality has increased in importance,
and that companies have to more clearly define which topics are material

- **there are 3 topic specific standards: social, environmental and economic.**

The Global Reporting Initiative (GRI)

- The underlying idea of the GRI approach has been to **enhance the quality** of sustainability disclosures by standardising the way different organisations report, thereby making the information **more consistent and comparable** both over time as well as across organisations.
- Helping organisations engage with reporting, and also aiding them to focus on the more relevant questions.
- A key role here is played by **materiality analysis**, which has been a core feature of the GRI guidelines since the G4 version published in 2013.
- With materiality considerations at the centre of the reporting process, organisations need to evaluate and focus on the most essential sustainability matters. These are evaluated **not only from the perspective of the organisation's activities, but also from the viewpoint of the stakeholders**.

What are the GRI standards about?

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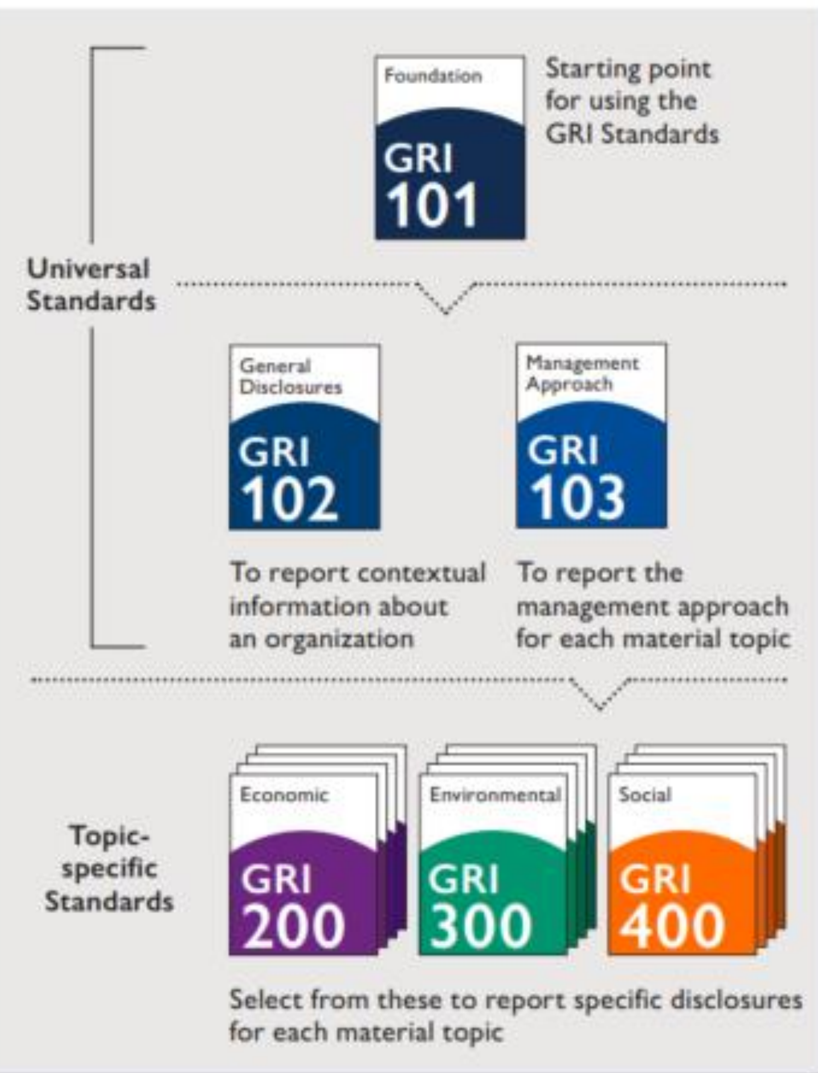
- GRI's Framework is the most widely used and recognized multi-stakeholder approach for disclosing economic, environmental, social, and governance information about a company's performance and impact

Video: The GRI Sustainability Reporting Standards: The Future of Reporting - YouTube

the report should cover material aspects, which are those aspects that reflect the organization's significant economic, environmental, and social impacts **or that really influence stakeholders' assessments and decisions.**

What are the GRI standards about?



https://www.globalreporting.org/how-to-use-the-gri-standards/gri-standards-english-language/

Source: GRI standard 101

Global Sustainability Standards Board (GSSB)

- The GRI Standards are issued by the Global Sustainability Standards Board (GSSB), an independent multi-stakeholder standard setting body created by GRI.
- The role of the GSSB is to ensure that the GRI Standards are developed in the public interest, through a multi-stakeholder, transparent and independent process. The Standards are developed according to due process and all meetings are recorded and available on GRI's website.

SASB STANDARDS (now part of the IFRS Foundation)

- SASB aims to create sustainability reporting standards that help organisations produce material information to **investors** in a cost-effective way.
- the SASB guidelines aim at simplifying the process, and define material aspects **on the level of the industry**.
- Purpose: help firms cost-effectively identify and manage a well-defined set of key sustainability performance indicators; provide investors with comparable and concise information to aid decision-making.
- SASB Standards enable organizations to provide industry-based sustainability disclosures about risks and opportunities that affect enterprise value. In August 2022, the IFRS Foundation assumed responsibility for SASB Standards when it merged with the Value Reporting Foundation, which previously maintained these Standards.

SASB STANDARDS (now part of the IFRS Foundation)

- SASB Standards identify the subset of environmental, social and governance issues most relevant to financial performance and enterprise value for 77 industries. The Standards were developed using a rigorous and transparent standard-setting process that included:
- evidence-based research;
- broad and balanced participation from companies, investors and subject-matter experts; and
- oversight and approval from the independent SASB Standards Board.
- Global investors recognise SASB Standards as essential requirements for companies seeking to make consistent and comparable sustainability disclosures.

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SASB STANDARDS (now part of the IFRS Foundation)

- The IFRS Foundation's International Sustainability Standards Board (ISSB) has committed to building on the industry-based SASB Standards and adopting SASB's industry-based approach to standards development. SASB Standards play an important role in the IFRS Foundation's *Climate-related Disclosures Exposure Draft* and *General Requirements for Sustainability-related Disclosures Exposure Draft*. The ISSB encourages companies and investors to continue to support and use the SASB Standards until they are replaced by IFRS Sustainability Disclosure Standards

Integrated Reporting Framework (now part of the IFRS Foundation)

- >Used to accelerate the adoption of integrated reporting across the world with an aim to:
  - Improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital
  - Promote a more cohesive and efficient approach to corporate reporting that draws on different reporting strands and communicates the full range of factors that materially affect the ability of an organization to create value over time
  - Enhance accountability and stewardship for the broad base of capitals (financial, manufactured, intellectual, human, social and relationship, and natural) and promote understanding of their independencies
  - Support integrated thinking, decision-making and actions that focus on the creation of value over the short, medium and long term.

Sustainability reporting standard and framework

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Main users for the report	Stakeholders at large	Mainly investors, but also others	Financial markets, investors
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Which one do you support?

Source: Tregidga and Laine (2021)

CDP

- CDP is an investor-led initiative, originally founded under the name **Carbon Disclosure Project**, seeking to gather comparable information about corporate actions related to climate change.
- The CDP runs a large **dataset**, which has been collected through annual surveys of large corporations and other large organisations.
- The first Carbon Disclosure Project's survey was launched in the year 2000 and focused on collecting climate-related information from corporations at a time when organisations seldom included such information in their sustainability reports. Since then, CDP has expanded its scope, and it now hosts a large database of corporate information around **climate, water, forests and supply chains, hence the name change**.

TCFD

- Task Force for Climate-Related Financial Disclosure (TCFD)
- Launched in 2015.
- Focus on providing a framework for reporting the financial implications of **climate-related risks**, opportunities and dependencies.
- Underlying logic: markets are efficient and can hence be useful for solving the global climate emergency. The goal is to have organisations produce consistent, comparable and clear information regarding the financial implications of climate change, and then have markets efficiently evaluate and value the risks and opportunities. It is also pointed out that should the information be misleading, markets will effectively use that information to misallocate capital and thereby hinder societies' aim at curbing global climate risks.

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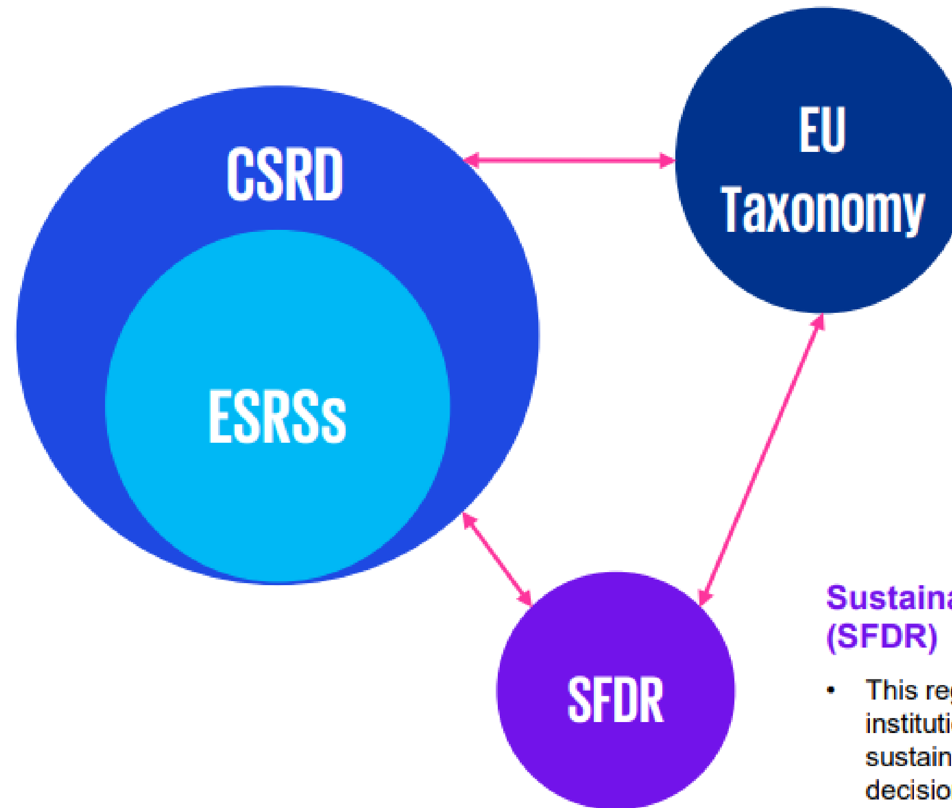
European sustainability reporting standards

(ESRSs)

Legal basis for applying ESRSs

Corporate Sustainability Reporting Directive (CSRD)

- The CSRD sets out which companies need to report sustainability-related information and when. The ESRSs support this with detailed reporting requirements.
- It is a key component of the EU's sustainable finance action plan[1] – which also includes reporting under the EU Taxonomy and SFDR.
- It requires companies to report on their sustainability-related information with the aim of:
  - providing investors and stakeholders access to necessary information for assessing investment risks related to climate change and other sustainability-related matters; and
  - establishing greater transparency about a company's impact on people and the environment.



EU Taxonomy

- The EU Taxonomy is a classification system that defines activities deemed to be aligned with a net-zero trajectory by 2050. It aims to help direct investment towards activities that will support the transition to a greener economy.
- As part of the CSRD, in addition to ESRS requirements, companies in scope are also required to report under the EU Taxonomy regulation. This regulation sets out specific KPIs about the extent of a company's sustainable activities.

Sustainable Finance Disclosure Regulation (SFDR)

- This regulation requires asset managers and other institutional investors to disclose information about how sustainability is integrated into their investment decision-making process. To report this information, asset managers and others captured by the SFDR require data from the companies they invest in.
- ESRSs are designed to provide this information, where material.

The CSRD does **not** apply solely for EU-based companies. Its scoping requirements capture a range of companies, including non-EU companies with significant operations in the EU and non-EU-based companies listed in the EU.

Source: KPMG (2023)

Legal basis for applying ESRSs

CSRD:

On 5 January 2023, the Corporate Sustainability Reporting Directive (CSRD) entered into force.

A broader set of large companies, as well as listed SMEs, will now be required to report on sustainability. Some non-EU companies will also have to report if they generate over EUR 150 million on the EU market.

The new rules will ensure that investors and other stakeholders have access to the information they need to assess the impact of companies on people and the environment and for investors to assess financial risks and opportunities arising from climate change and other sustainability issues.

Legal basis for applying ESRSs

CSRD:

The first companies will have to apply the new rules **for the first time in the 2024 financial year, for reports published in 2025**.

Companies subject to the CSRD will have to report according to **European Sustainability Reporting Standards (ESRS)**.

The standards are developed in a draft form by the **EFRAG**, previously known as the European Financial Reporting Advisory Group, an independent body bringing together various different stakeholders.

Legal basis for applying ESRSs

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EU taxonomy:

- The taxonomy is a **classification system** that defines criteria for economic activities that are aligned with a net zero trajectory by 2050 and the broader environmental goals other than climate.
- It helps **direct investments to the economic activities most needed for the transition**, in line with the European Green Deal objectives.
- A common language and a clear definition of what is ‘sustainable’.
- The EU taxonomy allows financial and non-financial companies to share **a common definition of economic activities that can be considered environmentally sustainable**.

https://www.youtube.com/watch?v=1O6YCCbHvHc

When and to whom will ESRSs apply?

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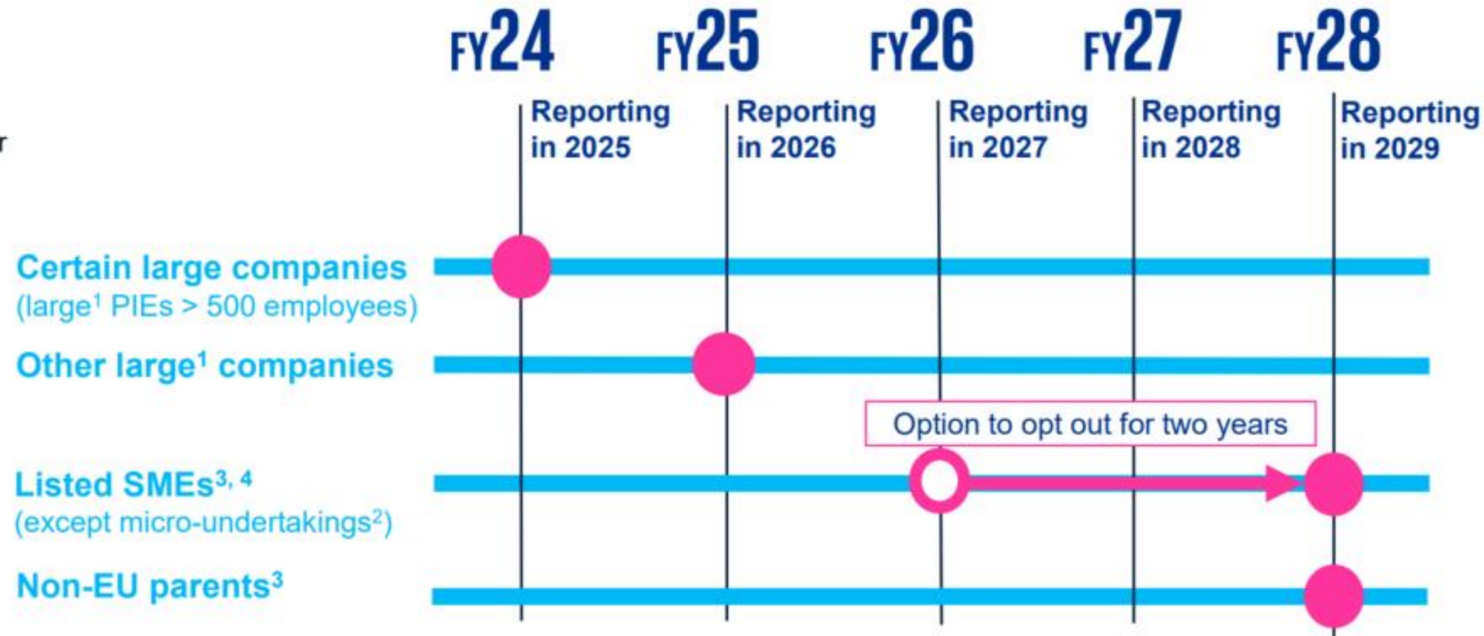
When: ESRSs will apply for years beginning on or after 1 January 2024 (reporting in 2025). Phased introduction will start with Public Interest Entities (PIEs) and companies with listed securities on EU-regulated markets which are large and have more than 500 employees (e.g. those already subject to reporting requirements under the NFRD).

Who: Ultimately, ESRSs will be applied by (group exemptions may apply):

- large EU companies[1];
- most companies with listed securities on EU-regulated markets (irrespective of whether they are based in the EU or not[2]); and
- ultimate non-EU parent companies[4] with a combined group turnover in the EU of more than EUR 150 million.



1. Large companies are those that, on the balance sheet date, exceed two of the following three criteria (including EU and non-EU subsidiaries): 250 employees, net revenue of EUR 50mn (formerly EUR 40m) or total assets of EUR 25m (formerly EUR 20m). The new thresholds take effect from FY 2024. EU member states can choose to adopt them early from FY 2023.
2. Exemptions apply, for example, for micro-undertakings (companies that do not exceed two of the following three criteria (including EU and non-EU subsidiaries): 10 employees, net revenue of EUR 900,000 (formerly EUR 700,000) or total assets of EUR 450,000 (formerly EUR 350,000) and for certain debt listings. The new thresholds take effect from FY 2024. EU member states can choose to adopt them early from FY 2023.
3. Separate standards will be developed for SMEs and non-EU parent companies.
4. Small and non-complex institutions and captive insurers are treated like listed SMEs (the option to opt out until 2028 does not apply unless they also meet the definition of an SME).

EFRAG will develop and publish additional sets of ESRSs in due course. These will include sector-specific standards, standards for SMEs and a standard on non-EU parent companies.

Source: KPMG (2023)

What has been released?

Ten topic-specific ESRSs

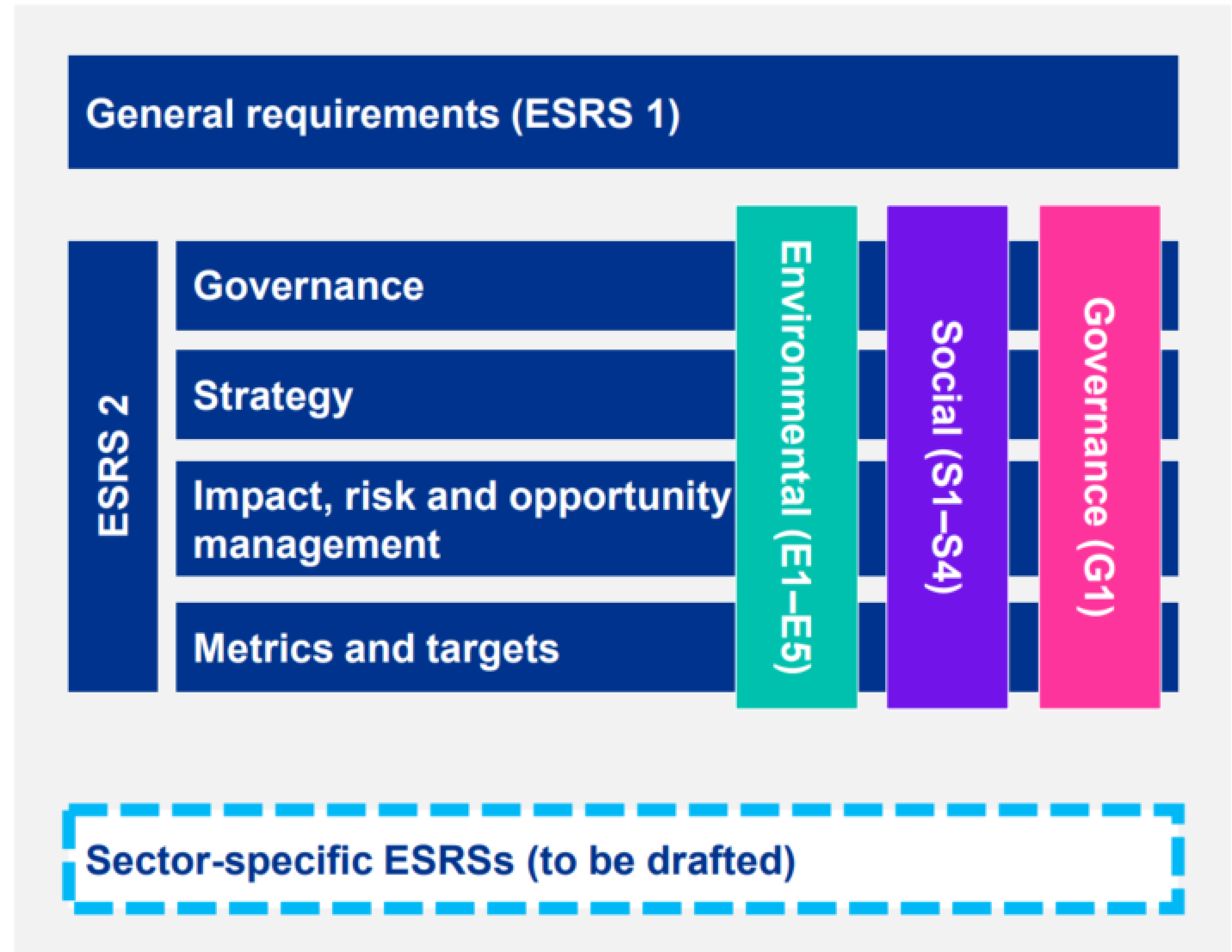
• Provide topic-specific disclosure requirements on:
- governance;
- strategy; and
- impact, risk and opportunity management.

• Establish metrics and explain how to disclose related targets for each topic.

Two cross-cutting ESRSs

· Explain fundamental concepts from the CSRD.

• Set cross-cutting disclosure requirements applicable to all topics for:
- governance;
- strategy;
- impact, risk and opportunity management; and
- metrics and targets.



Source: KPMG (2023)

What will companies need to disclose?

Four reporting areas

- **Governance** – disclosures relating to the governance of sustainability topics will apply to all companies.
- **Strategy** – disclosure requirements in this area will apply to all companies and topics.
- **Impact, risk and opportunity management** – disclosures on impacts, risks and opportunities will need to be provided for topics that are assessed as material.
- **Metrics and targets** – specific sets of sector-agnostic metrics and targets will need to be disclosed for material topics by a company, regardless of its industry.

Three reporting layers

- **Sector-agnostic disclosures** – disclosure requirements applying to all companies (for maximum comparability).
- **Sector-specific disclosures** (standards under development) – disclosure requirements applying to companies of a specific sector (for maximum relevance).
- **Company-specific disclosures** – additional disclosure requirements on material impacts, risks and opportunities not covered by topical standards.

Source: KPMG (2023)

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Conclusion:

Sustainability and sustainability reporting

Sustainability reporting frameworks

European sustainability reporting standards (ESRSs)