Chapter N

ESG indicators and SME: towards a simplified framework for sustainability reporting

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**Abstract.**

The transparency of corporate disclosure represents one of the fundamental pillars of corporate governance. Sustainability reporting is a corporate practice of public reporting of company economic, environmental, and social impacts and of its contributions towards sustainable development. Sustainability reporting helps internal and external stakeholders to make informed decisions and to be aware of how the company approaches sustainable development. Alongside the mandatory information, companies provide voluntary information with the aim of differentiating themselves from competitors and making themselves better known by investors. However, this practice is still uncommon for SMEs. This is understandable given the complexity of existing information frameworks - which combined offer more than 5,000 KPIs - and competing data requests from customers and financial institutions. All of this makes the collection of sustainability data extremely difficult and costly for SMEs, which have limited financial and human resources for such spending. In this context, emerges the need for ESG (Environmental, Social, Governance) rating methodologies to be adapted to SMEs. In fact, although the main non-financial rating agencies are now focused on large companies, ESG criteria are entering the investment decisions of an increasing number of funds, and more and more investors are called upon to apply these parameters also to companies of smaller size. Small and medium-capitalization companies have peculiarities that require an ad hoc approach to be correctly represented by an ESG assessment. This work, therefore, aims to analyze the state of the art through a review of the scientific and gray literature on ESG criteria and their applicability to SMEs and to develop a conceptual model for identifying sustainability KPIs and ESG criteria for SMEs.

**Keywords.**  ESG; Sustainability; SME; Sustainability reporting; Non-Financial Disclosure.

# N. 1. Introduction

In recent years, in many countries, including Europe, the so-called sustainable finance has been developing, which is different from the traditional one because it has not only, and not primarily, the goal of achieving economic results, but also the control and management of the social and environmental impacts produced by the investments themselves in a medium- and long-term perspective. Corporate disclosure is defined in the accounting literature as the communication to the public of corporate financial statements (Aǧca and Önder, 2007) or, more broadly, as the communication of economic, financial, and non-financial information, quantitative or related to the financial position and the corporate performance (Owusu-Ansah, 1998). Sustainability reporting is a corporate practice of public reporting of its economic, environmental and social impacts and its contributions to sustainable development. This practice helps internal and external stakeholders to make informed decisions and to be aware of how the company approaches sustainable development (Global Reporting Initiative, 2016).

Corporate disclosure is defined as mandatory when it consists of information disclosed in order to meet the minimum requirements imposed by laws and regulations; any information exceeding these limits is considered voluntary, taking the form of a free choice on the part of the company management to provide accounting and other information, deemed relevant to the decision-making needs of the recipients of the company’s annual reports (Meek et al., 1995).

In recent years, the number of companies that voluntarily disclose information about their environmental commitment (mainly in terms of energy efficiency, recycling and waste, and renewable energy), their commitment to improving their relationships with internal and external stakeholders, and related corporate governance, has increased enormously. Companies are disclosing their efforts as they believe that good corporate governance minimizes management and reputational risks and maximizes the profitability of capital in the medium and long term.

At the heart of non-financial reporting are Environmental, Social, and Governance (ESG) indicators. ESG reporting is a well-established concept in the financial sector as a basis for evaluating the sustainability of investments. The ESG criteria are now used in the financial sector to assess the sustainability of investments, as a way to provide an overall assessment of a company that goes beyond purely economic results. In other words, it is increasingly common to consider performance against specific ESG criteria when assessing an investment, namely the risk/return profile of portfolios.

Experience shows that ESG criteria are distinctive characteristics of a company’s quality in the long run. Companies that take ESG considerations more seriously are generally better managed, more sustainable and forward-looking. Companies with high ESG scores are better prepared to deal with crises and perform better on average than their competitors. The integration of ESG standards into investments aims to maximize the long-term return on the portfolio by better managing its risk exposure. ESG criteria used in sustainability reporting fall under both types of corporate disclosure as they are in some cases mandatory while they fall under voluntary reporting when they are applied by companies as a strategic choice towards sustainability.

The application of ESG (Environmental, Social, Governance) rating methodologies to Small and Medium Enterprises (SMEs) is still largely unexplored today. Indeed, although the main non-financial rating agencies are now focused on large companies, ESG criteria are entering into investment decisions of an increasing number of funds, and more and more investors are called to apply these parameters to smaller companies. However, mid-low cap companies have peculiarities that require an ad hoc approach to be properly represented by an ESG assessment.

**N.2. Review of the literature**

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### N.2.1. The Non-Financial Reporting Directive

Considering the legislative provisions in the European context, then from the mandatory reporting, the Directive 2014/95/EU (Non-Financial Reporting Directive) that was implemented in Italy with Legislative Decree N. 254 of 30 December 2016 with effect from 25 January 2017, sets minimum reporting standards for the ESG characteristics of companies in the European Union. The Directive establishes the obligation for larger companies to report regularly on the company’s main ESG issues. Reporting on "non-financial" factors may be part of the regular financial statements or be published as a separate document, also subject to an external audit by an authorized auditing firm. The decree provides that the reporting contains information to the extent necessary to include the development, performance, position and impact of the issuer’s business on the five areas of information envisaged, namely environmental, social and employee issues, respect for human rights and anti-corruption and bribery.

With regard to the reference standard, it is possible to use reporting methodologies issued by authoritative supranational, international or national bodies, of a public or private nature, or, alternatively, the use of autonomous evaluation methodologies is allowed if it is considered that the standard methodology is not suitable to correctly and clearly meet the information requirements required by the legislative decree and the Directive, provided that the adopted methodology is effectively justified and described (D. Lgs 245, 2016).

*N.2.2. Corporate Sustainability Reporting Directive (CSRD)*

In the wake of the EU Green Deal and the ambitious Sustainable Finance strategy, on 21 April 2021 the European Commission adopted its proposal for a Corporate Sustainability Reporting Directive ("CSRD”) which will review and extend the reporting requirements introduced by the Non-financial Reporting Directive ("NFRD").

Compared to the version of Directive 2014/95/EU that introduced for the first time the issue within the European Community legal system, the proposal presented:

* Extends the requirement for sustainability reporting to all large companies (companies with more than 250 employees) and to all companies listed on regulated markets including SMEs (with the sole exclusion of listed micro-enterprises, that are enterprises with less than 10 employees and turnover or assets with a balance sheet of less than €2 million).
* It requires the verification of the information provided by an independent third party (auditing firm) as already provided by Italian legislation.
* Introduces more detailed reporting requirements - to fully inform external and internal stakeholders about the company’s impact on social, environmental and governance factors - aligned with the sustainability reporting standards that will be shared across the EU and that in the meantime will allow for international comparison.
* It imposes the obligation to include non-financial reporting in the document relating to the Management Report (thus forming a single document with the financial statements and their annexes).
* The application of the new directive should start from 01 January 2023 with obligations for companies to conform to the financial statements published in 2024 and for the year 2023 with possible further slippage for SMEs to 2026.

Like the NFRD, the type of "sustainability information" to be disseminated will cover at least the following subjects: (i) environmental issues; (ii) social and labor issues; (iii) respect for human rights; and (iv) anti-corruption and bribery.

*N.2.3. ESG criteria for non-financial disclosure*

Instruments of responsibility, including disclosure of information responding to Environmental, Social and Governance (ESG) issues are pivotal in order to make visible the ethics of the company and its compliance with international standards to safeguard human rights, workers, and the environment,

The integration of ESG criteria can therefore improve the risk/return profile of portfolios. These three ESG factors are essential to assess the sustainability and related risks of an investment position:

* (E) Environment means more attention to issues such as CO2 emissions and climate change, population growth, biodiversity, and food security.
* (S) Social, refers to concerns of companies about human rights, working conditions, child labor and equality.
* (G) Governance is a criterion that mainly covers factors such as the quality and diversity of supervisory boards, the remuneration of managers, shareholders' rights and the elimination of corruption.

The international business environment offers many standards, guidelines, and reporting frameworks that entities can adopt when preparing a non-financial report. Companies considering the potential implementation of an ESG reporting framework should be aware of the variety of reporting standards that have been developed by standards managers around the world. As the various standards cover overlapping ESG topics but outline disparate reporting requirements, a continuous effort has been made to align standards with specific ESG reporting categories. For example, in terms of climate reporting, the Corporate Reporting Dialogue ("CRD"), a platform convened by the International Integrated Reporting Council, has been working on its "Better Alignment Project", since November 2018, to assess the alignment of the TCFD’s disclosure principles between its participating standards makers, such as SASB, GRI, CDP (formerly Carbon Disclosure Project), the Climate Disclosure Standards Board ("CDSB") and the International Integrated Reporting Council ("IIRC").

The goal is for these standards to help companies to better measure and manage their ESG risk exposures and become better corporate citizens by measuring, disseminating and managing the environmental and social impacts they create.

# 3. Material and methods

As a strategy to support a sustainable development, the research tries to figure out how to implement ESG criteria in SMEs. The objective of this paper is double: on the one hand, it seeks to contribute to the literature on ESG indicators, which is still developing a shared and common definition and practices, on the other hand, it seeks to be a useful and practical tool for the various stakeholders in the sector, who want to improve their environmental, social, and economic performance and disclose their sustainability strategy. Through an extensive literature review the paper explore the state of the art of the scientific literature and gray literature on ESG criteria and their applicability to SMEs and to develop a conceptual model for identifying sustainability KPIs and ESG criteria for SMEs.

**4. Results and discussions**

Although there is no legal obligation under the NFRD Directive for SMEs to disclose non-financial information, many of them are under increasing pressure from their parent companies to provide certain non-financial information in order to meet group reporting requirements (Steinhöfel et al., 2019).

Key stakeholders, such as corporate customers who are introducing sustainability and transparency requirements into their supply chain, are also putting pressure in this field.

All this, however, involves a considerable effort for SMEs that fail to meet these requests due to insufficient human and financial resources and are penalized in terms of access to the investment market or in difficulty with the requirements of the companies (Durst and Gerstlberger, 2020).

In fact, data from the Global Reporting Initiative (the most widely used among many voluntary sustainability reporting standards) show that only 10-15% of companies using its standards are SMEs. This is understandable, given the complexity of existing information frameworks - which combined propose more than 5,000 KPIs - and competing data requests from clients and financial institutions (GRI & IOE, 2020).

Regarding the legislative requirements for SMEs in the European Union, the Commission, in view of these difficulties, has proposed that SMEs listed on regulated markets could use simpler reporting standards, tailored to the ability of SMEs to comply with their legal reporting obligations, while non-listed SMEs may decide voluntarily to use them. In addition, reporting obligations for SMEs would apply from 1 January 2026, so that they can better manage the transition phase, also considering the extra challenges faced following the COVID-19 emergency. To further address these issues, the European Commission plans to publish SME-specific sustainability reporting standards by 31 October 2023, taking into account the capabilities and characteristics of SMEs. These will also be addressed to SMEs outside the scope of sustainability reporting under the Accounting Directive.

This standard will make it easier for SMEs to report on sustainability and reduce administrative costs. To achieve this, the standards should specify the key sustainability indicators that SMEs can reasonably report on and, most importantly, the methodologies and support tools that will allow them to be easily calculated. This relates in particular to: greenhouse gas emissions; energy intensity; information on activities and resource use related to an increased risk of impact on climate, biodiversity and deforestation; a clear guide to inform on climate transition plans and sustainable activities; due diligence on human rights; meaningful labor indicators.

**N.5. Conclusions and future perspectives.**

The challenge, therefore, is to ensure that SMEs, in addition to aligning themselves with the various obligations, can exploit the opportunities relating to specific types of investment and the possibilities of increasing "quality" of their actions by integrating ESG rating methodologies with traditional disclosure. From this point of view, in addition to the EU, other private entities and representative associations have made efforts in this direction. Particularly, Confindustria recently published in collaboration with the GBS the "Guidelines for the sustainability reporting of SMEs". The aim of this document is to provide a concrete framework to help SMEs approach sustainability reporting by providing simply and adaptable KPIs developed considering the different sizes of the enterprise. This document is the first instrument, created specifically for SMEs, to approach this type of reporting through questions regarding governance and compliance, economic performance, circular economy, environmental management, people, working relationships and diversity, responsibility towards customers, suppliers and supply chain, local community and territory. The document also provides a list of indicators that can be used depending on the specific sector of the company. This approach highlights as the only way to ensure that SMEs can adapt to ESG-based reporting is by simplifying and clarifying the areas in which they operate. Indeed, providing clear documentation and identifying the useful KPI is, at the moment, the best way to solve the shortcoming for SMEs that emerged from the analysis.

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