INTRODUCING THE ESG REPORTING
– BENEFITS AND CHALLENGES -

Laurențiu Paul Barangă[1*], Elena-Ioana Țanea[2]
[1), 2)] *Bucharest University of Economic Studies, Bucharest, Romania*

Abstract
Sustainable finance represents an important concern of the European Union lately, having an essential role in achieving the political objectives of the European Climate Pact. It is interpreted that it supports the sustainable development of economy, simultaneously reducing the pressures on environment and taking into consideration social and governance aspects.
The scope of sustainable finance is to improve the financial sector in the context of fighting against climate changes. Considering this purpose, the ESG factors (Environmental, Social and Governance) must be considered in the decisional process regarding the investments of the financial entities, promoting long-term investments in sustainable economic activities and projects.
There are many legislative actions at the European level, transposed into national legislation or with direct applicability in Romania for determining developing sustainable economies that beneficially impact the environment and climate changes. The action plan of the European Commission regarding developing a strategy for the sustainable finance contains ten initiatives grouped into three chapters: reorienting cash flow to a more sustainable economy, including sustainability elements in risk management, encouraging transparency and long-term vision.

Keywords
ESG, environment, social, governance, scoring.

JEL Classification
G30, G41, M14, Q50

Introduction

ESG represents environmental, social and governance factors which can affect the financial performance of an entity.

[*] Corresponding author, **Laurențiu Paul Barangă** – barangalp@yahoo.com.

Environmental factors refer to an entity impact on the environment (pollution, greenhouse gas emissions). They include climate mitigation, adaptation to climate changes, biodiversity protection, sustainable use and protection of water and maritime resources, transition to a circular economy, waste avoidance and recycling, reduction of environmental pollution, healthy ecosystems protection, and sustainable use of lands.

Social factors reflect the entity's relationship with its employees, clients and other stakeholders. They assume compliance with recognised labour standards (no child labour, forced labour or discrimination), safety and health at work, adequate remuneration, equitable work conditions, diversity and developing opportunities, trade union rights, product safety guarantee, and consideration of the interests of communities and social minorities.

Governance factors mirror how an entity is directed (internal control, transparency, audit) and they include fiscal honesty, anticorruption measures, sustainability management, remuneration of the Board of directors, data protection guarantee, and information disclosure.

Considering the novelty of ESG reporting, companies are faced with more questions about what and how they need to report, assessing the advantages and disadvantages of new regulations.

This paper aims to define ESG considerations, viewed from three perspectives: investment advisors, financial entities and the issuers, in the context of adapting the main actors to the new ESG reporting frameworks. Thus, it provides an opinion about the strengths and the struggles of implementing ESG, using the literature review study as a working methodology.

In the following, we will discuss about ESG reporting, the benefits and the challenges brought with it and finally, we will detail the steps Romanian companies have taken to implement ESG, to align with the new environmental requirements.

1. Literature review

The ESG problematics are new and for that reason, the literature does not include many researches regarding the impact of these topics on all the stakeholders identified by the new EU regulations issued to apply the European Climate Pact.

According to Henisz, W. et al. (2019), a strong ESG proposition can create value for the business, improving equity returns and linking to cash flow in five important ways: facilitating top-line growth, reducing costs, minimising legal interventions and regulations, increasing employee productivity, optimising investment and capital expenditures.

A study made by Broadstock, D.C. et al. (2021) about the impact of the ESG during the COVID-19 financial crisis in China, showed that ESG performance lowered financial risk, considering CSI300 constituents.

However, a research realized by Prol, J.L. et al. (2022) concluded that optimized ESG equity portfolios in the NYSE for two years provided a lower return and lower volatility that the less optimized ones.

Given its new character, there are several concerns arising about ESG disclosure: ensuring consistency and relevance in reporting frameworks, the elements of ESG scoring, understanding performance and materiality, transparency and public and regulatory engagement, as mentioned by Boffo, R. et al. (2020).

2. ESG benefits

Strong implementation of the ESG framework can create value for the business, improving equity returns and linking to cash flow in five important ways: facilitating top-line growth, reducing costs, minimising legal interventions and regulations, increasing employee productivity, and optimising investment and capital expenditures.

Top-line growth - A strong ESG proposition helps entities to achieve new markets and to expand into existing ones. When companies gain government authorities trust, they are more likely to get approvals, licenses and access that provide growth opportunities.

Cost reductions - ESG implementation can also contribute to costs reduction, by lowering energy consumption and reducing water waste.

Reduced legal interventions and regulations - As mentioned before, gaining government authorities trust can be beneficial to the companies, helping them to achieve greater strategic freedom and less regulatory pressure. This can lead to earning government support in future actions, for example obtaining subsidies.

Employee productivity increase - A strong ESG perspective can attract and retain quality employees, boost employee motivation and increase productivity.

Investment and capital expenditures optimization - ESG approach can improve investment returns by using capital in more sustainable actions that are beneficial to the entity for a long-term period.

In addition to those presented above, there are also the following benefits brought by the implementation of ESG principles: ensuring consistency and relevance in reporting frameworks; ESG scoring; understanding performance and materiality; transparency; public and regulatory engagement.

Ensuring consistency and relevance in reporting frameworks - The recent years had provided multiple ESG frameworks and given the fact that there is not a global standard for ESG, each company has to be careful in disclosing ESG information, aligning with the reporting frameworks and keeping updated with all the changes, ensuring consistency and relevance in what they report.

ESG scoring - ESG scoring appeared as a necessity to ensure protection of the investors and to allow comparability through companies to know which one promotes a better ‘green’ vision and which one is better to invest in. However, establishing ESG scores is not an easy task for companies that are already trying to familiarize themselves with the multiple reporting frameworks.

Understanding performance and materiality - The materiality concept appeared as a need for addressing the most significant concerns related to ESG. Materiality aligns with performance, as it refers to the ESG risks that are relevant to a company, which eventually will influence the profitability of the entity. A company's materiality assessment is important as it tells which problems are the most important, the ones that bring a significant impact on the financial health of the firm.

Transparency - The new reporting frameworks focus on transparency and the obligation of the companies to comply with the regulations. Sustainable Finance Disclosure Regulation (SFDR) indicates a few directions for the companies to be considered transparent: publication of information on policies on the integration of sustainability risks on the internet, publication on the internet of the main negative effects of the investment decision on sustainability factors, a statement of due diligence policies, establishing remuneration policies in terms of sustainability, providing results of ESG risk assessment.

Public and regulatory engagement - To illustrate the alignment with the ESG initiative, the companies have to make sure they engage the public and regulatory in their actions, also improving investors' confidence. Thus, the promotion of sustainability actions is essential. For example, this kind of information can be promoted on the companies' websites, in press articles and during participation at national or global conferences that addresses ESG and sustainability subjects.

3. ESG reporting

ESG reporting represents the disclosure of environmental, social and governance information. This has the purpose to improve transparency to the investors and determining the companies to give attention to the climate changes, by implementing specific actions and eliminating greenwashing. The ESG reporting is defined through the following regulatory: the EU Taxonomy, the Sustainable Finance Disclosure Regulation (SFDR), the proposal for Corporate Sustainability Reporting Directive (CSRD).

EU Taxonomy establishes a unified understanding of environmentally sustainable economic efforts in the EU through a system for classifying sustainable activities and setting performance thresholds, represented by technical screening criteria for six environmental goals: mitigation of climate change, adaptation to climate change, sustainable use and protection of water and marine resources, the transition to a circular economy, prevention and control of pollution, protection and restoration of biodiversity and ecosystems.

The purpose of the *SFDR Regulation* is to achieve greater transparency on sustainability in the financial services sector by setting out obligations to suppliers and distributors of financial products and services to inform the customers about the impact of sustainability risk on the profitability of investments and the impact of investments made on sustainability and also promoting environmental or social characteristics.

The proposal for *CSRD Directive* is to replace Directive 2014/95/EU (Non-Financial Reporting Directive) in its entirety and amend the provisions of the Directive on annual financial statements, consolidated financial statements and related reports of certain types of undertakings (2013/34/EU), the 'Transparency Directive' (2004/109/EC), the 'Audit Directive' and the 'Audit Regulation' (2006/43/EC and 537/2014). The proposal for CSRD aims to extend the reporting obligations of sustainability information to all large companies and all companies with securities listed on regulated markets in the EU, with the exception of micro-enterprises, to require reporting on a full range of sustainability information relevant to the company's activity and to ensure that the reporting is in line with the mandatory EU sustainability reporting standards that will be developed by the European Commission. It requires also that sustainability information to be subject to a limited assurance provided by auditors and enforces companies to prepare their financial statements and management reports in a digital format, labelling sustainability information.

The proposal for CSRD Directive stipulates that Regulation (EU) 2019/2089 of the European Parliament and of the Council, complemented by Commission Delegated Regulations (EU) 2020/1816, (EU) 2020/1817 and (EU) 2020/1818, brings the requirement to disclose environmental, social and governance (ESG) information for the construction of EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks. Regulation (EU) No 575/2013 of the European Parliament and of the Council enforce large institutions, which have issued securities that are admitted to trading on a regulated market to disclose information on ESG risks from 28 June 2022.

Regulation (EU) 2019/2033 of the European Parliament and of the Council and Directive (EU) 2019/2034 of the European Parliament and of the Council, which presents a new prudential framework for investment firms, contains provisions regarding the introduction of an ESG risk dimension in the supervisory review and evaluation process (SREP) by responsible authorities and contains ESG risks disclosure requirements, applicable from 26 December 2022.

4. ESG between benefits and challenges

From our point of view, ESG benefits and challenges must be visualised from three perspectives, where the key players are: investment advisors, financial entities and the issuers.

Investment advisors can develop now a new area of expertise in the ESG field, attracting new clients. However, to do that, efforts must be made. Thus, a continual documentation about ESG reporting frameworks and a new approach of adequacy tests to determine the risk profile of the investors got to be on their agenda.

Entities that have and promote a 'green' strategy are more appealing in terms of attracting capital and have a better reputation in the market. To provide access to this facility, they must comply with the Sustainable Finance Disclosure Regulation (SFDR) to meet transparency requirements. This means that they need to dedicate time, material and human resources to issue new internal procedures, that are well documented and to modify their policies regarding investments, risk, due diligence and remuneration based on the achievement of sustainability objectives.

Issuers are also favoured in attracting more buyers as they are promoting green instruments. Therefore, it is recommended that the financial investment prospectus has characteristics that are in line with environmental objectives, according to the EU Taxonomy.

Moreover, ESG reporting brings a new challenge also to the *financial auditors*, that must create a new approach of audit engagements to provide an additional limited assurance report. They will need to invest time into professional development in the ESG area, communication with the client and developing new analysing skills and control keys in checking the entities' information.

5. Actions taken at the national level for the implementation of ESG

To maintain the proper functioning of the internal market for the benefit of the investor, to improve the functioning of the internal market and to ensure a high level of investor protection, it was necessary to introduce a regulatory framework setting out minimum requirements for the EU benchmarks for climate transition activities, the EU benchmarks aligned with the Paris Agreement (allowing asset portfolios to be aligned to limit global temperature growth to 1,5˚ above pre-industrial levels).

In this regard, two new categories of benchmarks for low-carbon impact activities have been regulated. These new benchmark rules are also applicable to benchmark providers. In Romania, the Bucharest Stock Exchange (BVB) is currently the only entity authorized by The Financial Supervisory Authority since June 24, 2020, as administrator of benchmarks. As of February 08, 2022, the first ESG scores of 12 companies listed on BVB are available on the BVB Research Hub platform.

The national provisions regarding transparency on sustainability in the financial services sector have been included in Law 158/2020 for the amendment and completion of some regulatory acts. In this law, it has been envisaged to detail the modalities of monitoring by ASF of certain requirements set out in the Regulation (EU) 2019/2088.

Conclusions

During the research, we learned that, in the long term, the benefits brought to the investment advisors, entities, issuers and environment are worth the efforts made in assimilating and familiarizing with the new regulations regarding ESG. The research is based on the current regulations issued so far, our recommendation being to extend it when the other ESG related standards (proposal for a Directive on corporate sustainability due diligence and annex, proposal for Corporate Sustainability Reporting Directive – CSRD, proposal for European Green Bond Regulation – EuGBR, proposal for other delegated acts in the form of Regulatory Technical Standards – RTS) will be published.

In conclusion, although ESG reporting brings new challenges to companies regarding consistency and relevance in reporting frameworks, ESG scoring, performance and materiality, transparency and public and regulatory engagement, it is a necessity for the environment, that in the end facilitates top-line growth, costs reduction, minimisation of legal interventions and regulatory, employee productivity increase, investment and capital expenditures optimization.

Implementing ESG reporting impacts all the financial entities, making them to redefine their activities and the techniques for promoting the financial instruments, to modify the internal policies (due diligence, remuneration), redefining risks framework and to ensure training for a specialized human resource, to comply with the new professional competence requirements.

To achieve the environmental goals, companies and specialists in this field need to be open and always keep updated with the new legislation and good practices, creating an active network that acts for the benefit of a sustainable future.

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