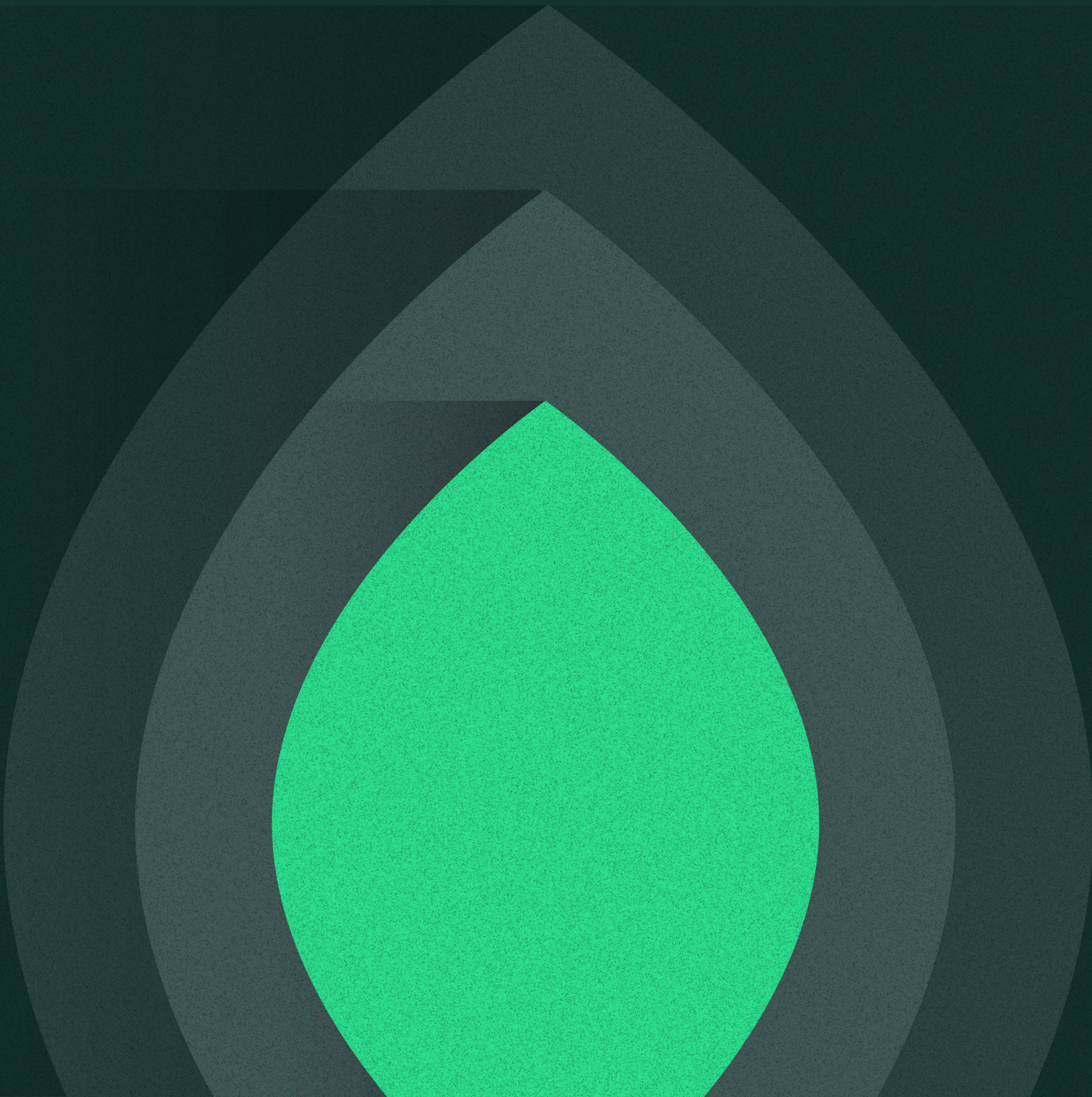
Payhawk

2023 Edition

ESG reporting:

Priorities for Finance Teams



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Introduction

Environmental, social, and corporate governance (ESG) is an essential consideration for a wide variety of private and public sector organisations. At its heart, ESG is part of a broader effort to create corporate guard rails for businesses to help protect the environment.

In this ebook, we will examine the importance of ESG reporting, examining everything you need to know about this critical topic.

The focus on ESG has accelerated in recent years, particularly since 2020, when the United Nations began releasing numerous incentives to overlay ESG data with sustainable development goals. The term was first used in a 2004 report entitled “Who Cares Wins” [1], a joint effort involving several institutions invited by the United Nations to contribute to the paper.

What is ESG Reporting?

ESG reporting is simply the disclosure of environmental, social, and corporate governance data. This information aims to ensure that investors can understand a company’s activities regarding environmental, social, and corporate governance areas. Not only does this form vital public information from which investors can make funding decisions, but it also helps them assess the ethical framework of a company. Conversely, it also represents an effective way for organisations to demonstrate that they’re meeting environmental goals and that their overall ethos towards ecological protection is genuine and authentic.

ESG reports reveal the various qualitative and quantitative benefits of activities related to a company’s ESG policies. The reporting allows investors to assess investments, aligning them carefully with their values. And it helps prevent companies from making moves that cause environmental damage, which investors, suppliers, customers, and the general public may view unfavourably — or even associate with corruption.

A study published in 2022 discovered that 89% of institutional investors considered ESG data in some capacity.[2]

What is the difference between ESG and sustainability?

Although these two terms are often used interchangeably, they do differ significantly. Sustainability refers to a direct relationship between a company and the environment. Whereas ESG extends that relationship to **social responsibility and rules around corruption**, providing a more holistic measure of the ethical value of a company.

In essence, ESG is an external investment framework based on metrics, providing investment and ethical information to all interested parties. In this sense, it also differs from sustainability, which can be seen as an internal framework guiding the capital investments of an organisation.

In a nutshell: Sustainability is the motivation, and ESG is the reported outcome.

As far as ESG is concerned, its reporting has become increasingly crucial for both companies and investors, with 92% of S&P 500 companies publishing this data in 2021.[3]

What does an ESG report contain?

As mentioned, an ESG report contains qualitative and quantitative data, including numbers, proof points, and information. As expected, companies must group the information under the three main themes: environmental, social, and corporate governance.

Typically, an ESG report will contain the following information:

- **Environmental**

Greenhouse gas emissions are a critical vector, particularly concerning targets for forthcoming periods. Investors will expect to see information on how a company combats climate change, reduces its emissions, and has plans to continue this.

- **Social**

Employee satisfaction is an essential aspect of the social component of ESG. Investors want to know how satisfied employees are with their current working environment and whether there are any areas for concern or improvement.

Companies must demonstrate that maintaining and improving safety in their working environment is a priority.

Businesses must also include a considerable range of demographic issues here. For example, what measures is the company taking to recruit from diverse backgrounds? Has it taken any action regarding gender inclusiveness? Is there any evidence of prejudice or jaundiced decision-making in the company?

Labour relations are also critical, and any company that is deemed to be exploiting its workers, or behaving in an unethical way, will certainly be marked down in this category

- **Governance**

This section is all about the workings of the company. It will refer to internal controls and processes and their design. Another critical issue in this section is executive compensation, which can be a hot potato issue that generates a lot of headlines.

Finally, this report section can often include whistleblowing procedures and whether the company offers dissatisfied parties a legitimate route to air any grievances.

What is an ESG score or rating?

ESG has become an illustrative part of assessing an organisation's viability and ethical values. It has become a priority for investors and businesses alike in a climate in which many are acutely aware of the conduct of companies, particularly those that are high-profile and successful. This can also be considered a demographic divide, with younger people more likely to be committed to an ethical outlook. AML Group's 2022 Investor Index found that 82% of investors aged 18-34 were willing to "take a hit" to support ethical investments.[4]

ESG scoring, therefore, aspires to grade organisations on their adherence to certain principles in the three areas covered. An ESG rating can be seen as similar to a credit score or bond rating, essentially denoting the ability of a company to meet its ESG commitments, its performance within these metrics, and its exposure to risk across the three areas, assigned by third-party providers.

ESG scores are calculated based on a set of ESG metrics. However, each agency will use a different set of criteria to score organisations, in a process similar to credit agency scoring, in which different agencies will also assign differing scores to various people and companies.

What is CSRD?

On 5th January 2023, the Corporate Sustainability Reporting Directive (CSRD) came into force.[5] This new directive of the European Commission modernises and strengthens rules relating to the social and environmental information that companies must report.

As part of the ESG process, the directive also broadened the range of companies required to report on sustainability, including many SMEs. The new directive is intended to ensure that investors and other stakeholders can access all necessary information to assess investment risks arising from sustainability issues.

The European Commission asserts that it will create a culture of transparency regarding the impact of companies on people and the environment. It also suggests that reporting costs should be significantly reduced [6] due to the new regulations, thanks to harmonising the information required for submission. Companies must account for the new rules in the 2024 financial year for reports published in 2025.

Running parallel to the CSRD regulations are the European Sustainability Reporting Standards (ESRS).[7] The European Financial Reporting Advisory Group (EFRAG) is an independent body that brought together stakeholders from various interested groups.[8] The standards are tailored to EU policies while also building on, and contributing to, international standardisation initiatives.

One of the most important aspects of the CSRD is that the legislation makes it mandatory for companies to audit any sustainability information they report.[9] This means that they can be audited at any time by the Commission and its auditors. It also provides for the digitalisation of sustainability information.

The CSRD is imperative for companies based within the Eurozone and US and UK companies operating across Europe. And businesses must become thoroughly acquainted with the CSRD guidelines and all required reporting formats.

What does corporate ESG look like in practice?

The benefits of ESG are pretty apparent, but what about the processes associated with the initiative? The most logical approach is to break the ESG guidance down into its three constituent components:

Environmental

Aside from regulations on investment, there are numerous other reasons that companies should embrace ESG guidance. By becoming more conscious of their environmental, social, and governmental responsibilities, businesses can foster innovation, create a positive image around their brand, reduce operational risks, bolster engagement with employees, and ultimately drive sustainable and responsible growth. Studies indicate that benefits gleaned from ESG far outweigh any negative consequences or perceptions.[10]

The above is extremely important in a culture in which people are becoming acutely aware of companies' ethical and moral conduct. In recent years, we have seen a significant amount of high-profile industrial action and protest, which reflects the wider perspective of society. By prioritising ESG, companies can create an ethos and image that resonates with the evolving needs and values of customers and communities.

Social

Social and societal aspects are primarily related to how the company treats its people and fosters relationships with the wider community. In seeking to address this goal, it will be particularly valuable for companies to address the following:

- Is everyone within the company treated equally, and do equal opportunities exist?
- Does the company deal with privacy issues and data protection within an adequate ethical and legal framework?
- Can people work safely, and to what extent are human rights enshrined within operations and the supply chain?
- Are customers being dealt with respectfully and receiving exceptional support and service at all times?
- Some organisations that assess ESG have an additional focus, too. These companies place some emphasis on limiting customer dependency on the company as a significant vector.

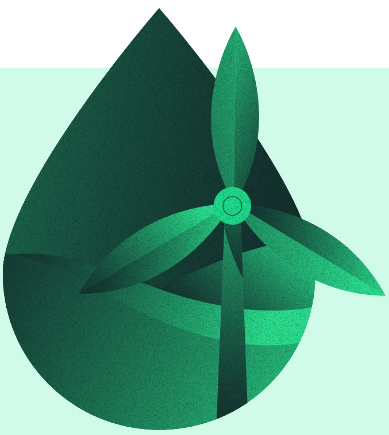
Governance

Concerning the governance aspect of ESG, companies should consider the extent to which they are vulnerable to unethical behaviour. For example:

- Is the company able to prevent bribery and corruption?
- Does the company embrace diversity in its board of directors?
- Is the remuneration of executives proportionate and in line with actual performance?
- Does the company pay its workers adequately across all pay grades and positions?

As per the above, companies should prioritise the following for their overall goals:

- Business activities should have the least possible negative impact on the environment and ecology of the planet
- Operations should be inclusive, fully accounting for all social and societal aspects while ensuring that no individual or demographic is excluded in any way
- Organisations should put ethical and strong governance in place across all areas of the business in a joined-up and cohesive way
- Companies should assiduously track their environmental impacts, including air and water pollution, greenhouse gas emissions, and consider how they handle waste products



The importance of transparent, up-to-date ESG reporting

CSRD is ultimately intended to create optimal transparency regarding all areas of ESG performance. It aims to ensure that the various factors of comparison between companies are easier to measure in an effort to prevent companies from concealing poor performance.

Of course, assessing the overall impact of a major corporation operating across multiple territories is extremely difficult. ESG will never be perfect. But as its regulations are steadily developed, it does become a valuable guideline for assessing the conduct of some of the world's most powerful and successful companies.

Timeliness is also crucial in ESG reporting. Any stakeholders interested in ESG reporting naturally require timely data so that they can make decisions related to a particular financial year. Business leaders must therefore have access to ESG information and reporting based on a unit of time, with the preference tending to be monthly. This makes it easier for companies to observe trends quickly and anticipate any adjustments that must be made to their sustainability policy. Being conscious of this time requirement for ESG reporting should be a priority for all companies under the radar.

What does ESG mean for companies?

Traditionally, finance teams were focused on accurate financial reporting and maximising profits. However, now they must also play a role in measuring every activity and investment associated with the three underpinning components of the ESG process, including operating results and supply chain impacts.

Finance teams will need to evolve to achieve all of the above. And CFOs and other Senior Leaders must leverage technology to balance measuring profitability and ESG impact in their business processes.

Why should finance teams care about ESG?

Investing in the ESG process is essential for finance teams for several compelling reasons, including the following.

Risk management

Firstly, risk management is inherently entwined with the ESG process, as ESG factors can present multiple financial risks to companies. As finance teams are often responsible for assessing and managing risks within an organisation, they immediately become interested in the ESG process, particularly because the risks associated with ESG factors can seriously impact a company's long-term financial performance.

As an example, environmental risks, such as climate change and resource scarcity, can profoundly impact a company's supply chain, affecting operational costs and regulatory compliance.

Social risks, such as labour practices, human rights issues, and product safety, can also lead to legal liabilities, reputational damage, and even customer boycotts. And it hardly needs to be stated that these can all have a massive impact on profitability. There are also a range of governance risks that can significantly impact a company's finances. Weak board oversight or ethical misconduct can result in fines, legal actions, and loss of investor confidence.

Only by assiduously considering ESG factors will finance teams be able to identify and mitigate these risks. And this could literally be the difference between the success or failure of a company.

Financial benefits

Incorporating ESG practices can also deliver cost savings and improved operational efficiency. In accordance with this, a study from MSCI found that companies with high ESG scores, on average, experienced lower costs of capital compared to companies with poor ESG scores in both developed and emerging markets during a four-year study period, while the cost of equity and debt followed the same relationship.[11]

Energy-efficient technologies and a sustainable attitude to resource consumption can reduce energy bills and waste disposal costs while also limiting overheads.
Implementing sustainable supply chain practices can reduce transportation costs, improve supplier relationships, and even lead to discounts or more favourable rates.
As finance teams analyse the potential financial benefits of ESG initiatives, they will doubtless identify better ways to allocate resources that will ultimately be valuable to businesses and their revenue.

Access to capital

Investors will increasingly include ESG considerations in investment decisions because they are a strong indicator of long-term sustainability and value creation.
Finance teams should therefore understand that delivering strong ESG performance can enhance the attractiveness of a company or a company to investors and thus increase or decrease the likelihood of investment. It could also lead to better capital access and lower borrowing costs. By aligning with ESG principles, companies effectively tap into an expanding pool of socially responsible investors and funds.

Regulatory compliance

As governments and regulatory bodies are implementing stricter ESG regulations, getting ahead of the curve is advisable. Increasing pressure will bear down on finance teams to comply with these regulations, and the consequences will become more severe for those who fail to do so.

Non-compliance will increasingly result in financial penalties, legal consequences, and reputational damage. Staying informed about evolving ESG regulation is essential.

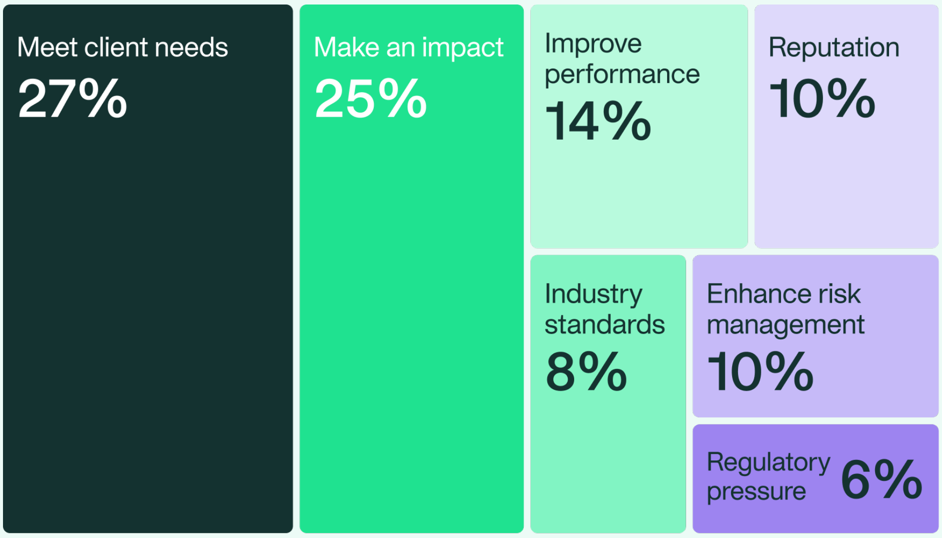
Stakeholder expectations

ESG has gained prominence due to increasing awareness from various stakeholders, including customers, employees, communities, and advocacy groups. This has led to a collective expectation among these important people, and therefore, meeting these expectations has become critical for companies. By integrating ESG considerations into financial strategies and decision-making, finance teams can build trust with valued stakeholders, earning credibility with investors.

Ultimately, ESG will become increasingly inseparable from financial performance, risk management, cost savings, access to capital, regulatory compliance, and stakeholder expectations.

What is the primary reason your organization has adopted, or would adopt, ESG?

Meeting client needs and making a positive impact are key ESG drivers



With reference: 2. Capital Group. (2022). Study finds nearly two-thirds of investors globally prefer using active funds to integrate ESG .

What are the finance team's responsibilities around ESG?

The responsibilities of finance teams when it comes to ESG can vary depending on the specific organisation. However, there are some broad areas where finance teams will typically play a role across all companies, here's what that might look like:

Strategy and integration

Finance teams collaborate with senior management to develop and integrate ESG strategies into overall business strategy. This involves identifying relevant ESG factors, setting measurable goals, and establishing performance metrics to track progress. Finance teams also play a role in assessing the financial implications of ESG initiatives.

Risk assessment and management

Finance teams evaluate and quantify the financial risk associated with ESG factors. This involves risk assessments, scenario analysis, and stress tests to identify potential ESG-related risks. Based on these findings, finance teams develop risk mitigation strategies, implement appropriate controls, and monitor ongoing risk.

Financial reporting and disclosure

Finance prepares accurate and transparent financial reports which incorporate relevant ESG information. They collaborate with internal departments, such as sustainability or corporate responsibility, to gather data on ESG performance. Finance teams may also play a role in complying with ESG reporting frameworks, industry standards, and regulatory requirements.

Capital allocation and investment decisions

The finance team assesses the financial viability of ESG initiatives and whether they fit into the overall picture of the company while assisting with allocating resources on this basis. Evaluating the financial return, cost savings, or risk associated with ESG investments is essential. Working closely with external stakeholders, finance teams also seek to raise capital for any projects related to ESG, while seeking funding from sustainable sources.

Investor relations

Working closely with investors, analysts, and rating agencies, finance teams must communicate their companies' ESG performance and financial prospects. This involved providing accurate and timely ESG-related information, responding to investor inquiries, and participating in meetings and conferences dedicated to ESG.

Compliance and governance

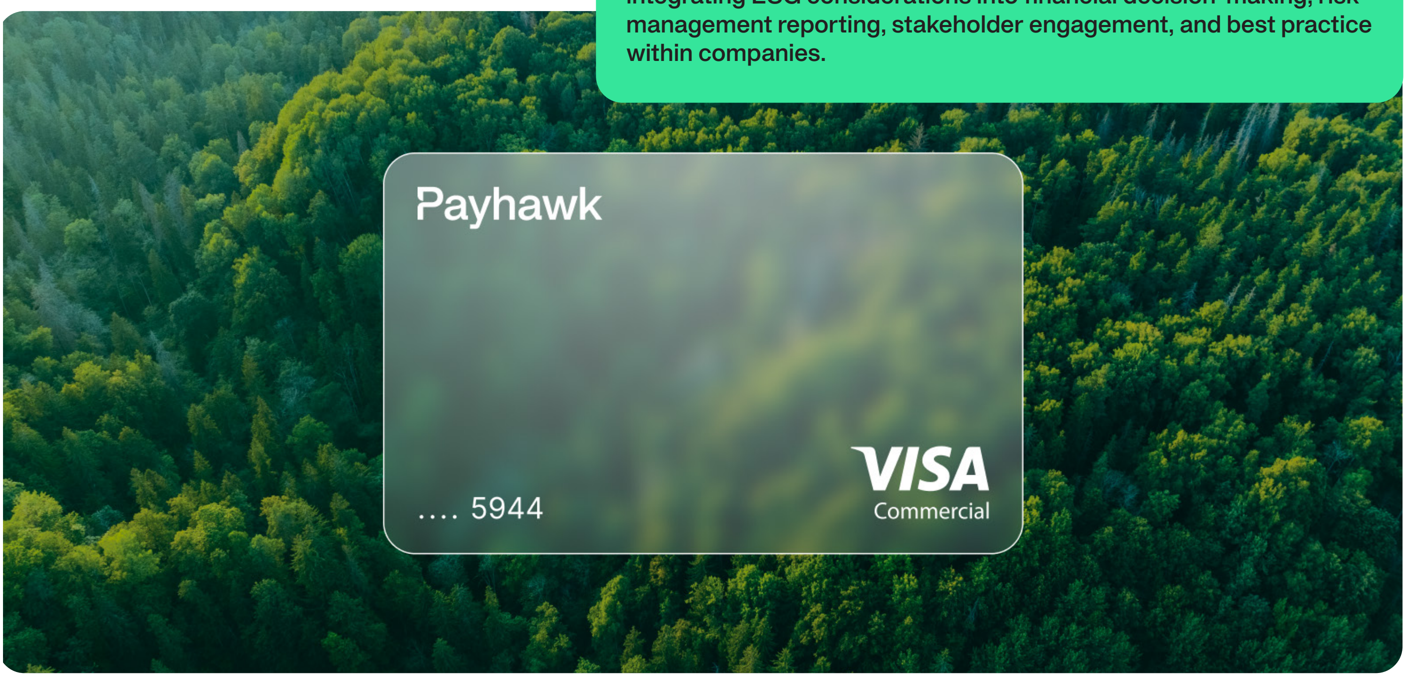
Compliance is critically important, and finance teams contribute to this by remaining updated on evolving ESG regulations, diligently assessing reporting requirements, and maintaining governance standards. Finance teams may also contribute to enhancing internal controls, ethics, and governance frameworks, strengthening the company's position on ESG practices.

Performance monitoring and measurement

Finance teams also monitor performance across the organisation. Establishing performance metrics, developing dashboards and reporting tools, and analysing relevant financial data.

Finance teams must identify areas for improvement, provide insights on financial performance trends, and support the ongoing improvement of practices across the organisation.

In summary, finance teams play a critical and wide-reaching role in integrating ESG considerations into financial decision-making, risk management reporting, stakeholder engagement, and best practice within companies.



Expenditure management in relation to ESG

Finally, corporate spending is one of the most critical areas related to ESG reporting. All financial transactions provide vast information on attitudes towards sustainability, and capturing these will be essential in achieving a viable ESG score.

There are numerous considerations for companies in this area, including the following:

- Do they purchase goods from sustainable suppliers?
- Do they make purchasing decisions that can be deemed sustainable?
- Can they develop knowledge and skills within the company by seeking external training?
- Do they make unnecessary flights or travel in an ecologically damaging way?
- Can they incorporate energy-neutral transport and other processes into everyday practices?

Tracking corporate spending is extremely difficult. Particularly within larger organisations, with many departments. It can be an almost insoluble task to track down who is spending money and what they're spending it on. With legacy expense management solutions, expenditure is often not particularly transparent, so adherence to ESG remains a massive challenge for various companies.

Next steps

As detailed, ESG has gained significant importance in business as investors and stakeholders increasingly recognise the need for sustainable and responsible practices. Integrating ESG considerations can help companies mitigate risks, improve long-term performance, attract investors, enhance reputation, and contribute to a more sustainable future.

However, ESG is a broad and evolving field, with various frameworks, ratings agencies, and methodologies used to assess companies' performance - especially across different countries. So the best thing a finance team can do now is ensure their technology can make measuring, reporting, and improving as easy as possible with intelligent technology and planning.

Environmental

Social

Governance

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About Payhawk

Payhawk is a leading spend management solution for domestic and international businesses throughout Europe, the US, and the UK. Combining company cards, reimbursable expenses, accounts payable, and seamless accounting software integrations into a single product, Payhawk makes business payments easy — for everyone. Payhawk helps customers in over 32 countries to maximise efficiency, control spending at scale, and stay agile. With offices in London, Berlin, Barcelona, Paris, Amsterdam, Vilnius, Sofia, and New York, Payhawk's diverse customer base includes top names like LuxAir, Babbel, Vinted, Wallbox, and Wagestream.