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The challenge and opportunity of ESG reporting for SMEs

The issue of sustainability is in the spotlight like never before. 64% of respondents to a global survey carried out by the UN described climate change as an emergency; one that required decision-makers to step up on their ambitions. And with the UK due to host the COP26 summit in November, two thirds of the British public want the country to become a world leader on climate change.

Businesses have a key role to play in achieving this. Under increasing pressure from their citizens, governments around the world have introduced nationwide Environmental, Social and Governance (ESG) standards, and made ESG reporting mandatory for publicly listed companies. Small and medium sized businesses (SMEs), however, while typically perceived as more sustainability conscious than their corporate counterparts, have been less able to report on their commitment to sustainable business.

Given its benefits, it would clearly be in their interests to do so. A *McKinsey study* found that *ESG* could improve a company’s operating profits by as much as 60 percent, for example, while VC funds have increasingly begun to adopt ESG benchmarks when choosing their investments. Fortunately, as the ESG market matures, reporting is becoming more accessible, and technology is making it easier for SMEs to report their impact more effectively.

The rise of ESG reporting

Part of the impetus for VCs to use ESG metrics has been driven by greater regulation. In March 2021, for instance, the EU introduced a green taxonomy for the financial sector. The *Sustainable Finance Disclosure Regulation (SFDR)* has made it mandatory for asset managers, VCs, private banks, and other financial institutions to disclose ESG credentials on their websites and in their annual and quarterly reports.

Germany went a step further in May, announcing that ESG reporting would become mandatory for all sectors as part of its new *Sustainable Finance Strategy (SFS)*. The UK is making important strides in this area, too, becoming the first country in the world to make the *Task Force on Climate-Related Financial Disclosures (TCFD)* mandatory, as well as announcing plans to introduce its own ESG framework, largely in line with the European Union's.

Even ahead of these measures, forward-looking VCs were already asking for ESG reporting from their portfolio, driven by social responsibility and an understanding that startups who report on sustainability perform better than those who don't – by up to 4.8%, according to *Harvard Business School*.

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SMEs that can demonstrate their ESG commitments in hard numbers have a competitive advantage. They gain greater access to capital, and will also be able to manage risk more effectively, minimising regulatory interventions that may slow down growth. ESG measures have also been shown to increase efficiencies, reduce costs, and increase employee productivity. Furthermore, companies with strong sustainability policies are more likely to have a strong reputation and greater trust among partners and customers.

But, while the case for SMEs to look at their ESG is strong, it is not without its challenges. As any company trying to raise funding will know, it is difficult enough to report on financial performance, let alone on issues such as its carbon footprint or the transparency of its supply chain. Moreover, ESG reporting frameworks are fragmented and often complex with many SMEs finding them daunting to engage with. After all, while VCs have begun using the same criteria to measure SMEs as they do for corporations, there must be an acknowledgement that early-stage companies are time poor, and don't have the same resources at their disposal. They simply can’t afford to bring in an expensive consultancy firm or a team of data analysts.

Overcoming these challenges is not impossible, of course. Any company wanting to unlock the competitive advantage of ESG reporting should look to take the following five steps:

1. Identify the sustainability issues that affect your business – Known in the sustainability world as a “materiality assessment”, the first step is to identify the ESG issues that impact your business. This should involve talking to your key stakeholders – customers, partners, employees and investors – and determining what issues are important to them. Fundamentally this is where the company establishes its values as a business and the sustainability issues that it is going to champion.
2. Identify the relevant ESG frameworks – While mandatory regulation on ESG is slowly being adopted, identifying relevant voluntary frameworks and matching their ESG priorities to best practice, SMEs can get ahead of the curve and take advantage of the head start they have against slower-moving competitors. Businesses could start with world-renowned frameworks such as the Global Reporting Initiative (GRI), which helps businesses to measure a range of ESG issues from carbon emissions to human rights and compliance. They should also try to identify any frameworks specific to their industry and research what their competitors are doing.
3. Gather the data you need – Through the materiality assessment and identification of the relevant frameworks, businesses will have defined a shortlist of issues they need to report against and the data they need to gather. In order to reduce the cost and resources required for this, SMEs should do what they do best – find technology that overcomes the problem. In today’s digital world, nobody needs to face the pain of manual reporting – find a tool that automates the entire process for you.
4. Report against your data – Transparency is a fundamental tenet of ESG. Customers, investors and the public are wary of companies that partake in “greenwashing” – laying claim to social good to boost brand reputation while not truly committing to sustainable business. Therefore, once SMEs begin gathering this data, they need to report against it and demonstrate an audit trail which validates that the data they are providing is accurate. Again, technology can help here – blockchain has huge potential for demonstrating an immutable audit trail of ESG data.
5. Repeat – Founders nervous about beginning the ESG reporting should remember that creating sustainable business practices is an ongoing process. Every company has to go on a journey to become more sustainable, identifying issues affecting the business and changing practices over time. But companies can only begin on this journey if they have the data to understand where they stand on ESG in the first place.

> Once the reporting process begins, SMEs should conduct it iteratively to demonstrate successes over time but also to identify new opportunities, challenges and future risks as the business grows.

The spotlight is slowly turning on SMEs to begin reporting on ESG, but those who begin the work now, and demonstrate their commitment to investors and the wider market, gain a first-mover advantage. There is an opportunity for forward-looking entrepreneurs to lead on social causes while also improving the performance of their business – the time to start is now.

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