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TOWARDS A SUSTAINABLE FUTURE: THE INTEGRATION OF ESG IN FINANCIAL REPORTING

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Abstract:
The goal of this paper is to point out the need for standardized ESG frameworks to enhance transparency and stakeholder trust, as well as overall performance of reporting entity. Modern business requires encompassing Environmental, Social, and Governance aspects into financial reporting in order to provide business transparency and responsibility. Both qualitative and quantitative disclosures are required in order to compare performance against set goals and risks. Literature review shows that post-2008 financial crisis studies and recent COVID-19 research show companies with high ESG ratings have better financial and market returns and attract loyal investors. The International Sustainability Standards Board, established in 2021, issued IFRS S1 and S2 standards in June 2023, effective January 2024, to improve global sustainability reporting. Early adopters of comprehensive and effective ESG reporting have demonstrated superior performance in the global economy, and this trend is expected to persist.

Keywords:
ESG reporting, financial reporting, environmental, social, governance.

1. INTRODUCTION

Traditionally, dominant quantitative, and past-oriented financial reporting is becoming increasingly insufficient for the main stakeholders of a business. Contemporary business encourages social responsibility, encompassing the sharing of non-financial information on social and personnel issues, environmental protection, human rights, and anti-corruption efforts, among other aspects (Arvidsson & Dumay, 2022). ESG reporting is the process of compiling and disclosing reports by a reporting entity related to the effect of its processes on the environment (Environmental), the social environment (Social), as well as on how it manages the organization (Governance) (Raghavan, 2022). It encompasses both qualitative and quantitative disclosures related to all three aspects, usually presented in the form of a separate report. The report includes a comparison of the reporting entity's performance with previously defined goals, strategies, and ESG risks (Cohen, 2023). In industry practice, the terms ESG (Environmental, Social, and Governance), sustainability, and the terms CSR (Corporate Social Responsibility) reporting are often used interchangeably (Raghavan, 2022). Research has revealed that public companies with high ESG ratings experienced higher stock market returns following the 2008 financial crisis (Yin et al., 2023; Lins et al., 2017). Comparable studies were conducted following the onset of the COVID-19 pandemic, with consistent outcomes (Engelhardt et al., 2021). Common to both groups of studies is that there is the strongest connection between the Governance element and achieved returns and/or profitability (Gianfrate et al., 2021).

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Namely, public companies with quality ESG reporting attract investors and business partners who are more loyal and who will provide financial support in times of crisis; and/or successful public companies (less indebted and with more free cash flows) will have enough resources to finance quality ESG reporting, and such companies typically respond well in times of crisis. In addition to the aforementioned, global companies are incorporating the Sustainable Development Goals (SDGs) into their corporate social responsibility (CSR) objectives, particularly focusing on ESG issues. To address the world's social and environmental concerns, they establish precise goals with corresponding targets and indicators.

2. LITERATURE REVIEW

Generally, companies aim to maximize profit as their primary objective. Achieving this goal is often seen as a measure of success. They continually strive to enhance their value, as an increase in value reflects strong performance. This, in turn, boosts market confidence, which is based not only on current achievements but also on future prospects (Azahra & Hasnawati, 2024). In the contemporary business environment, investors increasingly consider a company's sustainability practices before making investment decisions. One such consideration is ESG disclosure, which has emerged as a key factor for investors. Over the past decade, numerous researchers have examined various aspects of ESG such as: information (Du Rietz, 2014), reporting (Camilleri, 2015), risk-adjusted performance (Ashwin Kumar et al., 2016), transparency of ESG reporting (Tamimi & Sebastianelli, 2017), investment decisions (Sultana et al., 2018), earnings management (Velte, 2019), financial performance (Velte, 2020), company value (Adhi & Cahyonowati, 2023; El-Deeb & El Banna, 2023; Wong et al., 2021), price inefficiency (Naeem et al., 2022), and brand impact (Puriwat & Tripopsakul, 2023).

ESG research has expanded into diverse industries including mining (Alandejani & Al-Shaer, 2023), banking (Bashatweh et al., 2021; Bax et al., 2020), manufacturing (de la Fuente et al., 2022), transportation (Maaloul et al., 2023), technology (Consolandi et al., 2022), real estate (Luo & Tang, 2022), materials (Ahmad et al., 2021), entertainment (Takahashi & Yamada, 2021), retail (Eliwa et al., 2021), services (Luo, 2022), health (Billio et al., 2021), and tourism (Huang et al., 2022). The continued interest among researchers in the development of ESG issues is evident from the literature.

When it comes to the field of accounting, there is a significant number of authors who have explored the topic with mixed results. Authors' (Zahid et al., 2022) results show a substantial inverse relationship between an organization's financial success, as measured by return on assets (ROA), and ESG. However, since customers reward ESG practices that enhance short-term performance, ESG has a positive effect on entity revenue. Likewise, Aydoğmuş et al. (2022) claim that both the environmental, social, and governance (ESG) scores individually, as well as the overall ESG score, have been shown to positively and significantly correlate with company's profitability. These findings suggest that excellent ESG performance by a company may lead to financial returns in the form of increased value and profitability. Furthermore, disclosure and implementation of ESG strategies can improve the value of an entity's products and increase the desire of buyers and investors to engage with the company, leading to better performance and higher revenues. ESG initiatives improve corporate image and revenue. In addition, research findings indicate a notable positive correlation between ESG and dividend payouts (Zahid et al., 2023). Consequently, companies demonstrating strong ESG practices showcase their commitment to stakeholders and shareholders, ensuring the continuity of dividend payments.

3. PROFESSIONAL REGULATION IN ESG

Sustainability considerations are becoming integral to investment decision-making, leading to a growing demand for entities to offer globally comparable, high-quality information about the risks and opportunities associated with sustainability. As a response, in November 2021, the International Sustainability Standards Board (ISSB) was established. Acknowledging the importance of current frameworks and the necessity for market streamlining, the International Sustainability Standards Bord amalgamates and utilizes the efforts of investor-oriented reporting endeavors, including (SASB Standards, 2024): SASB Standards; Task Force for Climate-related Financial Disclosures (TCFD) Recommendations; Integrated Reporting Framework; and Climate Disclosure Standards Board (CDSB) Framework.

The ISSB creates IFRS Sustainability Disclosure Standards with the aim of meeting the information requirements of investors and facilitating the efficient communication of decision-relevant information by companies to global capital markets. In March 2022, discussions began regarding issuing two new standards. The IFRS S1: General Requirements for Disclosure of Sustainability-related Financial Information and the IFRS S2: Climate-related Disclosures were released in June 2023. The proposed start date for applying these standards to financial reporting is January 1, 2024. In the following section the main requirements laid out by IFRS S1 and IFRS S2 will be presented.

3.1. THE REQUIREMENTS OF IFRS S1 AND IFRS S2

The following figure will illustrate the significance of SASB Standards in IFRS S1 and IFRS S2.

According to IFRS S1, organizations must report all sustainability-related risks and opportunities that may have an immediate, medium-term, or long-term impact on the reporting entity's cash flows, funding sources, or capital costs. Conversely, IFRS S2 mandates entities to divulge details about risks and opportunities in relation to climate. This disclosure aims to aid primary users of general-purpose financial statements in allocating resources to the reporting entity.

Companies can provide investors with the necessary information to understand the risks and opportunities associated with sustainability by integrating IFRS S1 and S2, along with additional resources such as the SASB Standards. The TCFD Recommendations are fully integrated into both IFRS S1 and IFRS S2. Companies that adhere to the TCFD Recommendations and the SASB Standards will be compiled according to the IFRS S1 and IFRS S2. As preparers and investors transition to adopting ISSB Standards, the ISSB actively encourages them to do so and will continue to maintain and enhance the SASB Standards as long as they are in use.

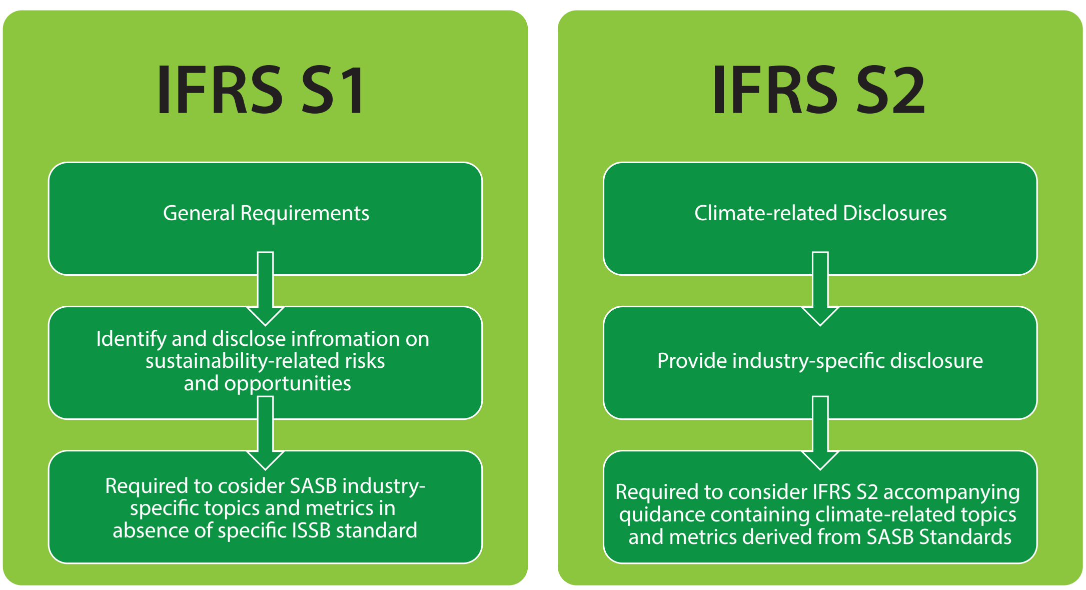
3.2. LEGAL REGULATIONS IN THE REPUBLIC OF SERBIA

Under the Law on Accounting of the Republic of Serbia, Article 34 (Official Gazette of RS No. 73/2019 and 44/2021 - other laws), 2024) companies are required to disclose information about investments aimed at environmental protection within their Annual Business Report. According to Article 37 of the same law, entities required to submit non-financial information are substantial, publicly-interested entities employing more than 500 people on average during the reporting period as of the balance sheet date. The non-financial report includes data necessary to understand the evolution, performance, position, and outcomes of its operations. This data pertains, among other things, to environmental preservation, social and human resource concerns, observance of human rights, efforts to combat corruption, and matters related to bribery. In addition to the mentioned regulations, the Global Reporting Initiative (GRI) standards are the most often utilized sustainability reporting guidelines in Europe (GRI Standards, 2024). The next section will have these standards in focus.

3.3. THE REQUIREMENTS OF GRI STANDARDS

These standards enable organizations of all sizes, whether public or private, to assess their effect on the environment, economy, and society comprehensively and reliably. In addition, previous will enhance transparency regarding their contributions to sustainable development. Such norms are highly advantageous to a broad spectrum of stakeholders, including capital markets, investors, legislators, civil society, and corporations alike (GRI Standards, 2024).

Figure 1. The significance of SASB Standards in IFRS S1 and IFRS S2.



Source: (SASB Standards, 2024).

The Standards (the Universal Standards, the new Sector Standards, and the topic Standards) are crafted as a user-friendly modular system, providing a comprehensive view of an organization's significant topics, their impacts, and the methods used to manage them. The revised Universal Standards are applicable to all organizations and now include due diligence on environmental and human rights reporting, aligning with intergovernmental standards. The new Sector Standards facilitate more uniform reporting on sector-specific impacts. The Topic Standards, modified for use with the revised Universal Standards, outline disclosures applicable to specific topics.

4. ESG REPORTING IN PRACTICE

An organization's ESG performance and effects are communicated through the ESG report, although the format, content, and target audience of these reports can vary. Many companies are gradually embracing ESG reporting to fulfill stakeholder demands for information and to demonstrate their commitment to managing ESG risks. The increasing demand for global disclosure standards and high-quality data is being propelled by investors' and regulators' growing need to evaluate how ESG concerns impact a company's enterprise value. While voluntary reporting frameworks and guidance exist, the absence of common standards has led to confusion among stakeholders. As a result, stakeholders have requested that the IFRS Foundation leverage its expertise in producing worldwide accounting standards to develop globally standardized sustainability reporting. Table 1 below provides an overview of selected examples of ESG reporting by the United States of America's companies across various sectors.

The table demonstrates a growing trend among corporations to integrate ESG reporting into their business practices, reflecting global changes regarding responsible and sustainable corporate operations. However, the varying approaches and lack of uniform standards indicate a need for further development and standardization in ESG reporting frameworks. Companies that excel in providing transparent and reliable ESG information are likely to gain a competitive advantage in attracting investors and maintaining stakeholder trust.

Table 1. Utilization of ESG, GRI, and SDGs in financial reporting of selected companies.

Company	Reporting
Compass Minerals	The business has taken steps towards sustainability, as indicated by its yearly ESG report complying with the standards established by GRI and SASB.
Eli Lilly	Its corporate social responsibility reporting traces back to 2012 and integrates the SDGs*.
Energy Recovery	In its yearly report, the company emphasizes the utilization of energy recovery tools to mitigate carbon emissions.
Etsy, Inc.	The 2019 annual reports featured ESG information, with external third-party validation of its ESG metrics.
IDEA	The company has established a multidisciplinary ESG team to address ESG issues comprehensively, and it plans to release its inaugural annual ESG report in 2020.
Johnson and Johnson	On a yearly basis, dashboards assess advancements made toward achieving SDGs.
Kimberley-Clark	The company has implemented GRI principles and aligns its objectives with SDGs.
Nestle	The 2018 report demonstrates adherence to the SDGs.
Nike	It employs the GRI framework in its Sustainable Business Report, with a particular emphasis on addressing SDGs.
Proctor & Gamble	Since 1999, the company has been publishing Corporate Citizenship Reports, with an emphasis on addressing SDGs.
Tex-Isle Steel company	Independent consulting firms have verified the company's dedication to sustainability.
Unilever	It utilizes the GRI framework and aligns with the SDGs.
UBS Group AG	The 2019 Sustainability Report, incorporates an independent assurance report following the guidelines of the International Standard on Assurance Engagement 3000.
Vornado Realty Trust	The accounting firm conducted an audit engagement following SASB Standards, along with a review engagement for sustainability disclosures aligned with GRI Standards.

* More on these SDG standards can be found here: https://unece.org/trade/wp6/standards-sustainable-development-goals-sdgs
Source: Adjusted from Raghavan (2022)

5. CONCLUSION

ESG reporting seeks to unveil a company's ESG impacts to all stakeholders. Employing contemporary technologies for ESG accounting and reporting, alongside a robust framework tied to the SDGs, can meet investors' informational demands and empower management in strategic decision-making. This approach mandates corporations to reveal both direct and indirect impacts, encompassing ramifications on economy and society. Inferior ESG performance relative to peers might lead to a competitive disadvantage in financial markets, consumer engagement, and talent acquisition. Pioneers in comprehensive and effective ESG reporting have witnessed success in the worldwide arena, and this pattern is anticipated to endure.

6. LITERATURE

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