MSc Thesis Business Management & Organisation

- Final version -

ESG-reporting by SMEs: What information are investors looking for?

Master Thesis

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Executive summary

Corporate Social Responsibility practices are becoming more of a normality in the business environment, where the corresponding reporting on Environmental, Social & Governance (ESG) factors have become of utmost importance. While Small- and Medium Enterprises (SMEs) are a major part of the world economy, there is a lack of research on ESG-reporting by SMEs. With upcoming legislation like the Corporate Sustainability Reporting Directive (CSRD), research on ESG-reporting becomes increasingly important. Adding onto that, we know very little on how investors utilise ESG-reports in their investment decision-making. Understanding the investors' perspective on ESG-reports can benefit SMEs in attracting investments. To address and contribute to this knowledge gap, this thesis is answering the main research question: *'How can SMEs implement ESG-reporting to differentiate themselves towards investors?'*, through answering three sub-research questions: *'What are the main challenges SMEs face related to ESG-reporting? (1)'*, *'What do investors value regarding sustainability? (2)'* & *'What is the requested key information investors look for in SMEs ESG-reports? (3)'*.

To answer the first sub-research question, this thesis has performed a literature review, where literature was collected through the data sources 'Scopus' and 'Google Scholar', as well as the snowballing method. Next to contributing towards understanding the knowledge gap, the literature review build the foundation for the qualitative data collection. This exploratory thesis employed semi-structured interviews as primary data collection method to answer the second and third sub-research questions. A total of 16 interviews were conducted with institutional investors from diverse backgrounds and different types of institutions. The interviews covered the interviewee's background, possible institutional sustainability guidelines, ESG subtopics, and the breakdown of the most important ESG subtopics. To analyse the data collected, two rounds of coding were applied to the most important quotations of interviewees. Afterwards, the examination of patterns and themes in the final list of quotations and codes resulted in the exploration of answers to the research question.

The main challenges SMEs face when implementing ESG-reporting were 'a lack of knowledge and resources', 'difficulties in implementing sustainability practices', 'limited staff and time', and the 'complexity of existing ESG-reporting tools'. The CSRD attempts to overcome several challenges through implementing a SME-specific standard of ESG-reporting.

Institutional investors were found to have company-specific visions and policies on sustainability. They focus on specific themes and transitions such as energy, food, circularity, digitalization, innovation, and resource use. Some investors align their policies with

governmental goals like the Sustainable Development Goals and the Paris Agreement. The source of investable money also influenced their sustainability policies, with government-funded investors prioritising environmental goals and private asset investors prioritising profitability alongside sustainability.

Institutional investors prioritise reliable, comparable, and verifiable data in ESG-reports. Environmental factors were generally given higher priority than social and governance factors. The importance of specific ESG-factors varied among different institutional investor types. Larger institutional investors emphasized the impact within the whole value chain, while regional development agencies showed particular interest in the impact on affected communities. Transparency from SMEs in the investment process was deemed essential, and the requested key information needs to be aligned with the data points included in the European Sustainability Reporting Standards draft.

Four propositions emerged from the findings, being: *'SMEs face different challenges in implementing ESG-reporting practices'*, *'Institutional investors value ESG-reporting in SMEs and seek specific key information'*, *'Transparency and comprehensive ESG-reporting enhance SMEs' chances of attracting investments'* & *'Tailoring ESG-reporting to investor preferences enhances SMEs' attractiveness towards investments'.* Future research should consist of building upon this study, focusing on the exploratory propositions addressed in this thesis.

List of abbreviations

CDP – Carbon Disclosure Project

CSR – Corporate Social Responsibility

CSRD – Corporate Sustainability Reporting Directive

EFRAG – European Financial Reporting Advisory Group

ESG – Environmental, Social & Governance

ESRS – European Sustainability Reporting Standards

GHG – Green House Gas

GRI – Global Reporting Initiative

SDG – Sustainable Development Goal

SEC – (U.S.) Security and Exchange Commission

SME – Small- and Medium Enterprise

SWOT – Strengths, Weaknesses, Opportunities & Threats

TBL – Trible Bottom Line

Chapter 1 Introduction

1.1 Background

In a moving business environment where Corporate Social Responsibility (CSR) practices are becoming a normality, the reporting of these CSR practices are becoming of utmost importance for companies to show their contribution to a more sustainable world. However, this sustainability reporting still lacks uniformity and are mostly voluntary reports of large corporations (Christensen et al., 2021). The business environment is gradually focusing more on reporting on Environmental, Social & Governance (ESG) practices, mainly to attempt at reaching the set goals of the Paris Agreement and the Sustainable Development Goals (SDGs) (UNFCCC, 2023; United Nations, 2023). Internal and external stakeholders' pressure businesses to report on their sustainable practices and be as transparent as possible, which in turn supports their reputation (Ramadhini, et al., 2020). In Europe, there are laws and regulations on its way that will force large companies, listed companies, and even listed SMEs to disclose information on their risks and opportunities regarding social and environmental issues (European Commission, 2022). Additionally, the U.S. Securities and Exchange Commission (SEC) will enforce regulations on this issue in the United States in a similar manner (SEC, 2022). With more regulation on the horizon, it can be beneficial for businesses, stakeholders, and society to move towards a more uniform ESG-reporting standard. These large changes in policies and legislation have significant implications for the future of ESG-reporting and the way businesses operate towards a more sustainable environment.

As research states, there is a positive relationship between firm size and the adoption, quality, and magnitude of ESG-reporting (Hahn & Kühnen, 2013). A large literature study on ESG-reporting shows that there is a lack of research on ESG-reporting by SMEs (Trautwein, 2021), while SMEs are a major part of the world economy, with more than 90% of all firms across the world falling within the SME-category (International Finance Corporation, 2012). Main reason for the results of Trautwein comes from the fact that SMEs do not often report nor measure their sustainability impact due to different challenges they face (Shields & Shelleman, 2017). However, with the upcoming regulations it is wise for SMEs to start acting and begin preparing for mandatory ESG-reporting. Not only because of the upcoming regulations, but to benefit their enterprise as well. ESG-reporting, if applied and implemented correctly, can bring along many benefits such as revenue increase, stronger competitive position, and better reputation among consumers (Wang et al., 2016; Shields & Shelleman, 2017). Additionally, ESG-reporting has large implications for internal and external stakeholders (Huang and

Watson, 2015; Dhaliwal et al., 2011; Solomon et al., 2011). These stakeholders include investors who may want to invest in SMEs. The SMEs can differentiate themselves through their ESG-reporting and possibly attract more investors and more funding (Trautwein, 2021).

Investors are increasingly seeking for sustainability in their potential investing opportunities. Investors show interest in the environmental performance of companies, with the businesses with the highest environmental performance gaining the most interest of investors (Miles & Covin, 2000). Additionally, investors can increase shareholder value through their activism for sustainability practices (Kim & Lyon, 2011). However, due to the lack of uniformity in ESG-reports, investors experience trouble comparing investment opportunities and complain about the lack of comparable and verifiable information (Bernow et al., 2019). In turn, companies seeking funding do not know what sustainability information investors find important. As stated by Christensen et al. (2021: pp 1233); "we know little about how investors and other stakeholders specifically utilize CSR information". Related to this, the authors also conclude that ESG-reporting standards have the potential to improve information for investors.

1.2 Research questions

The above-mentioned information shows that research on ESG-reporting is needed, with a focus on SMEs. This research project aims to contribute to the mentioned knowledge gap by exploring and identify the key information that investors look for in the ESG-reports of SMEs. To do so, the challenges that SMEs face while implementing ESG-reporting need to be identified first. This will be achieved through performing a literature review. Thereafter, this thesis will explore the investors' perspective on ESG-reporting, the key information investors look for in ESG-reports of SMEs and the value of this key information for investors. Identification of the key information will be made through a literature review, together with the conduction of interviews that shows the investors' perspective on ESG-reporting. This contribution will be made through addressing the following central research question:

'*How can SMEs implement ESG-reporting to differentiate themselves towards investors?*

This central research questions will be answered through multiple sub-questions, consisting of:

1. *'What are the main challenges SMEs face related to ESG-reporting?'*
2. *'What do investors value regarding sustainability?'*
3. *'What is the requested key information investors look for in SMEs' ESG-reports?'*

Chapter 2 Literature review

This thesis has performed a literature review to answer the first sub-question *'What are the main challenges SMEs face related to ESG-reporting?'* and provide a basis for the qualitative data collection. The literature has been retrieved from multiple data sources, mainly Scopus and Google Scholar. Articles have been assessed to originate from respectable sources. Search terms like 'ESG-reporting', 'sustainability reporting', 'sustainability legislation', 'CSRD implications', 'reporting standards', 'SME sustainability reporting' and 'investors sustainability' were used. Some articles were retrieved by using the snowballing method.

2.1 Reporting guidelines

Sustainability is seen as one of the most important themes in today's business environment. It has many implications for businesses in current day and time (Bateh et al., 2013) and it is a widely acknowledged key concept for the future of humanity (Will, 2008). Together with the growing importance of sustainability, the corresponding reporting of this concept has become a major subject as well. Most stakeholders think of sustainability as a requirement and expect businesses to act regarding their impact on sustainability factors (Dienes et al., 2016). These stakeholders desire more information disclosure by companies so that they may be held accountable for their actions and assess these companies on their impact related to sustainability (GRI, 2006). To show compliance with the increasing demand for sustainability practices businesses use ESG-reporting (Hahn & Kühnen, 2013). A large literature study done by Christensen et al. in 2021 showed the economic effects of ESG-reporting, with the main effects being that it can benefit the capital markets through greater liquidity, lower costs, and better resource allocation. Additionally, by publishing information on sustainable practices, companies seek to increase their transparency & legitimacy, protect their reputation & brand image, and increase their competitiveness in the business environment (Herzig and Schaltegger, 2006).

These ESG-reporting practices are slowly becoming a normality, in combination with the traditional financial reporting (Kumar et al., 2019). It is key to not only look for financial sustainability but to build on the Triple-Bottom-Line (TBL). The TBL was introduced by Elkington in the late nineties, referring to an accounting framework that build on three pillars: people, planet, profit (Elkington, 1997). This framework is still utilized in sustainability theories and goes hand in hand with the ESG-factors used in current day reporting practices. The ESG-factors were introduced to provide clarity to the world of sustainability issues and divide them

in three categories: Environment, Social and Governance. Around the 2000s, the usage of the concept of ESG-factors expanded and became increasingly accepted in the investment community (Lykkesfeldt, P., & Kjaergaard, L. L., 2022). The introduction of ESG-factors provided an easier, more accurate and more effective way of processing and analysing sustainability information (Hoang, 2018). With the reporting of sustainability practices being a voluntary and judgement-based tool prior to the introduction of ESG-factors, the reported information was inconsistent and questionable in their quality (Christensen et al., 2021).

Reporting guidelines have emerged in recent years to aid firms and impose rules to shape the content and procedures to more legitimate ways of ESG-reporting (Darnall et al., 2022). Implementing standards for ESG-reporting can potentially improve the quality and quantity of the information provided (Christensen et al., 2019; Orazalin & Mahmood, 2020; Darnall et al., 2022). There have been several attempts to introduce guidelines for ESG-reporting, with initiatives like the Global Reporting Initiative (GRI), the AA1000 Assurance Standard and the Carbon Disclosure Project (CDP) providing prominent reporting tools. However, creating a universal guideline is difficult and complicated, with some of the challenges being sector-specific interpretations, usage of metrics and the extent of the information provided (Eccles et al., 2012). A review of the most applied reporting frameworks shows that guidelines do not always provide honest information disclosure with corporations manipulating perceptions through hiding their actual practices, leaving out their 'bad apples' and applying greenwashing (Siew, 2015). As part of the European Green Deal made in 2019, the European Union is implementing new regulations regarding ESG-reporting. The Corporate Sustainability Reporting Directive (CSRD) is activated in the beginning of 2024, enforcing a broader set of companies to report according to their reporting standards. These European Sustainability Reporting Standards (ESRS) are still in development but will create set of standards that applies to all the firms that fall under the CSRD (European Union, 2022).

2.2 Implications for SMEs

While large corporations face high pressure from all stakeholders and need to adapt to a business environment that requires higher levels of sustainability, SMEs face these pressures from the external and internal environment on a smaller scale (Gholami et al., 2022). With SMEs being the backbone of the global economy, creating close to 70% of jobs and GDP worldwide (World Economic Forum, 2022), adapting to a changing business environment is also crucial for them (Belyaeva, 2018). This implicates that SMEs, in time, will have to adopt sustainable practices and apply the corresponding ESG-reporting. Legislation shows this matter

as well, with the CSRD being the first regulation that forces ESG-reporting upon listed SMEs (European Union, 2022). Additionally, the CSRD will provide SME-specific guidelines that non-listed SMEs can also utilize.

With legislation and guidelines coming up for all firm sizes, it is only a matter of time that all SMEs will have to adopt ESG-reporting to stay competitive in the market (Natarajan & Wyrick, 2011; Christensen et al., 2021). Furthermore, larger firms that fall under legislation with whom they do business with can pressure SMEs to comply to these regulations and guidelines as well (Morsing & Spence, 2019). The different sustainability scopes of the value chain also cause pressure towards SMEs. The value chain is divided into three different scopes. Scope 1 includes all direct emissions from the reporting company. Scope 2 includes issues like electricity consumption and heating & cooling. Scope 3 includes upstream and downstream activities, covering the whole value chain, and thus possibly many SMEs (Bergmann & Posch, 2018; Hertwich & Wood, 2018). The earlier SMEs start implementing ESG-concepts and ESG-reporting, the better these implementations translate into their business model, management structure and organizational culture. The implemented ESG-concepts and ESG-reporting can then comply with the stakeholder pressure they face (Christensen et al., 2021).

2.3 Implementation challenges of SMEs

Gholami et al. (2022) state that SMEs face a larger burden when implementing mandated ESG-reporting than large companies. An extensive systemic literature assessment by Trautwein (2021) showed that SMEs have little to no clear guidelines for ESG-reporting since most guidelines are aimed at large firms. Many characteristics of SMEs are not considered, and the needs of SMEs are not addressed. Most of these reporting guidelines and tools are very complex, require extensive knowledge and resources, and are too complex for the scale of SMEs (Arena & Azzone, 2012). Additionally, the required resources are relatively higher for SMEs than for large firms (Bergmann & Posch, 2018).

Shields and Shelleman (2015) have conducted a large literature study, outlining a ‘sustainability SWOT framework’ for SMEs reviewing (SME) sustainability literature (see *Appendix 1).* This framework gives a clear overview of internal and external threats and weaknesses SMEs face when implementing sustainability practices into their strategy. With ESG-reporting being an unavoidable strategic issue of SMEs, this framework shows a connection between challenges of sustainability implementation and ESG-reporting. Natarajan and Wyrick (2011) have shown that the largest internal and external barriers for SMEs in implementing sustainable practices are lack of information, lack of finance and lack of

expertise. With the available literature, a list of key challenges SMEs face while implementing sustainability practices – specifically focused on ESG-reporting – can be made. These key challenges are displayed in *Table 1.*

Table 1. **Challenges in implementation of ESG-reporting in SMEs.**

# Category	# Specific challenge	Source
1 Lack of knowledge	1 Not understanding the benefits	Natarajan & Wyrick, 2011
	2 Hiring costly third parties	Christensen et al., 2021
	3 Investing in staff expertise	Arena & Azzone, 2012
	4 Acquiring scientific and technical knowledge	Christensen et al., 2021
2 Lack of resources	1 Limited amount of staff	Shields & Shelleman, 2015
	2 Restricted amount of time	Pimenova & van der Vorst, 2004
	3 Lack of stakeholder engagement	Gholami et al., 2022
	4 Limited budget/capital	Arena & Azzone, 2012
3 Implementation	1 Changing management structure	Shields & Shelleman, 2017
	2 Lack of suitable reporting tools	Trautwein, 2021
	3 Dependence of manager	Arena & Azzone, 2012

Source: Author.

2.4 ESG-reporting content challenges

The challenges mentioned in *Section 2.3* are implementation challenges that SMEs face when applying ESG-reporting. As mentioned before, when looking at the reporting tools and guidelines available, the proposed key sustainability indicators are focused on large businesses instead of SMEs (Arena & Azzone, 2012). This causes additional challenges for SMEs based on the content-level of ESG-reporting. Examples include standards that require impact-measuring techniques for which SMEs do not have the resources or knowledge, and standards that ask for specific information on the value chain, for which SMEs do not have the position to acquire that information. Shield and Shelleman (2017) stated that the most relevant bridge to overcome this challenge is to make the ESG-reporting less complex for SMEs. This aligns with multiple implementation challenges mentioned in *Section 2.3,* because less complex ESG-reporting requires less knowledge, fewer resources, and no specific management structure. Making ESG-reporting guidelines less complex is something we can observe in practice as well. For example, the B Impact Assessment created by the B Lab builds on a simpler structure than most other guidelines and the content is targeted at SMEs, which explains their growing audience under SMEs (Shields & Shelleman, 2017). Another example is the European Financial

Reporting Advisory Group (EFRAG), that proposes simpler guidelines for SMEs than for large businesses. With the launch of the Corporate Sustainability Reporting Directive (CSRD) and the associated draft European Sustainability Reporting Standard (ESRS) that has been published, an extensive list of requirements has been made available. The CSRD provides a significant distinction between firm size, with SMEs having to comply to less complex regulation. The CSRD takes into account existing reporting standards like the Global Reporting Initiative (GRI) and the Carbon Disclosure Project (CDP) to provide an improved alignment for firms already performing ESG-reporting (SER, 2023). This contributes to better comparability and easier implementation by businesses.

2.5 Key information in ESG-reports

ESG-reporting guidelines attempt to make reported information more accurate, more legitimate and of better quality (Darnall et al., 2022). To make sure that companies successfully include the right information in their ESG-reports, EFRAG proposed the final draft of the European Sustainability Reporting Standard (ESRS) in early 2023. The ESRS employs a double-materiality approach, where businesses will have to report on both the impact of the sustainability topics on the company, and the impact of the company on the sustainability topics. The ESRS is divided into two parts, one that applies to all undertakings (sector agnostic) and one that is aimed at the different sectors (sector specific). This thesis will investigate the sector agnostic part, which all undertakings must to comply to. The sector agnostic standard is divided in two cross-cutting requirements and ten topical requirements. Together they form a structure of twelve topics that apply to all undertakings that fall under the CSRD. The ESRS structure is shown in *Figure 1*.

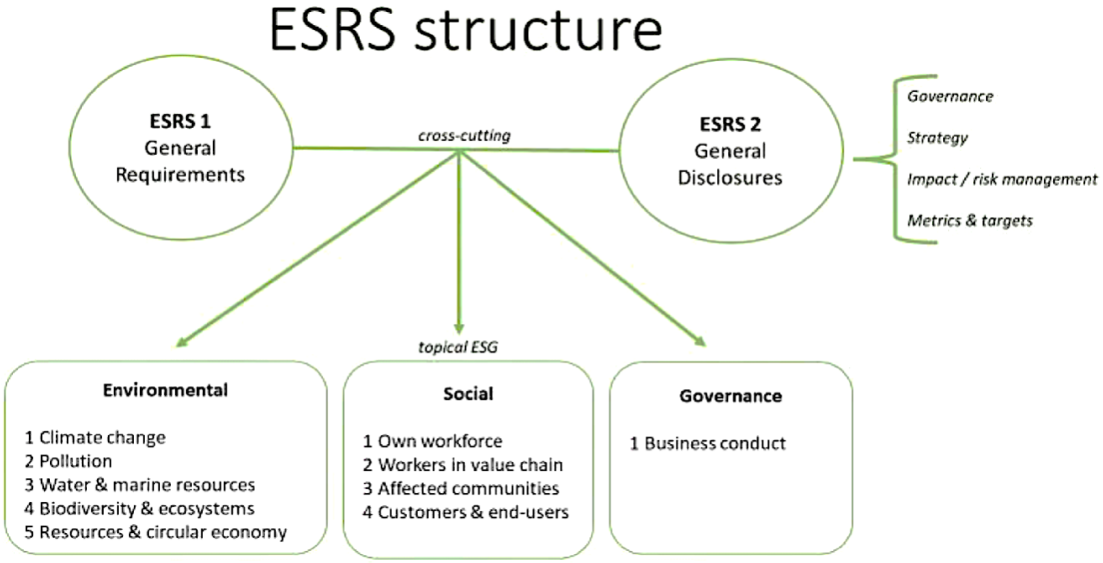

Figure 1. **ESRS sector agnostic structure (SER, 2023).**

The two cross-cutting standards contain general requirements and disclosures for the ESG-reports and form the basis of the ESG-report of any undertaking. The topical standards are built upon the three ESG topics, each containing specific subtopics: E1-5, S1-4 and G1 (*Figure 1*). The ten ESG subtopics are seen by the European Union as the most important and representative sustainability information. In the full ESRS draft, subtopic 'G1 Business Conduct' is further divided into six specified governance factors: 'corporate culture', 'procurement management', 'prevention and detection of corruption/bribery', 'confirmed incidents of corruption/bribery', 'engagement to exert political influence and lobbying activities' and 'payment practices'. A list of the key (sub)topics to be reported in ESRS can be found in *Table 2.*

Table 2. **Key information of ESG-reports.**

# ESG topic	# ESG subtopic	# Specified subtopic
1 Environment	E1 Climate change E2 Pollution E3 Water & marine resources E4 Biodiversity & ecosystems E5 Resources & circular economy	
2 Social	S1 Own workforce S2 Workers in value chain S3 Affected communities S4 Customers & end-users	
3 Governance	G1 Business conduct	G1.1 Corporate culture G1.2 Procurement management G1.3 Prevention and detection of corruption/bribery G1.4 Confirmed incidents of corruption/bribery G1.5 Engagement to exert political influence and lobbying activities G1.6 Payment practices

Source: Author, adapted from the ESRS.

The 15 ESG subtopics include over 1,000 datapoints that the ESRS requests in ESG-reports. It is not feasible for SMEs to report on all datapoints for every ESG subtopic. The SME-specific ESRS is expected to be published later in 2023 (SER, 2023). This SME-specific standard will be proportionate to SMEs and take their characteristics and capabilities into account. However, it will still be built on the topical ESG proposed by the sector agnostic ESRS (EFRAG, 2023).

2.6 Investors' perspective

Traditionally, investors make decisions based on two main financial considerations: profitability and risk (Cubas-Díaz & Martinez Sedano, 2018). The profitability consideration is based on an objective, with extensive and calculated analyses on the profitability of the investment. The risk consideration is based on the subjective perspective of the investor, with behavioral economics theories explaining this through risk-aversiveness (Virlics, 2013). In the past years, investors are increasingly looking for sustainable investments (Trautwein, 2021; Gholami et al., 2022). Considering not only the financial factors but also the ESG-factors will increase the accuracy of investment analyses (Cubas-Díaz & Martinez Sedano, 2018). Additionally, the increasing number of investors looking for sustainable investments leads to more investment-seeking firms adapting sustainable practices (Pástor et al., 2021). A study done by Berthelot et al. (2012) shows that investors appreciate ESG-reports, including those of SMEs. One of the reasons investors value ESG-reports is the expectation of future cash flows and thus the profitability of the investment project. Additionally, investors see sustainable activities of firms as critical to future competitiveness, showing a positive benefit for sustainable investments (Unruh et al., 2016). SMEs can use this information and influence the decision-making of investors through ESG-reporting and differentiate themselves from their competitors (Trautwein, 2021).

With no accepted ESG-reporting standard, investors experience barriers when including ESG-reports in their decision-making (Christensen et al., 2019). The lack of comparable and verifiable information in ESG-reports is one main barrier that investors complain about when making investment decisions (Bernow et al., 2019). Adding to that, investors continue to have concerns about the quality of ESG-reports and the legitimacy of presented data in these reports (Amel-Zadeh & Serafeim, 2018). A study done by Amel-Zadeh & Serafeim (2018) shows that investors still predominantly value financial performance within their ESG-investments. Additionally, they state that the interest in different ESG (sub)topics can vary between different kinds of investors. Investors seek ESG-reports that are materiality-based, implying the need for information in ESG-reports to be significant. Materiality-based ESG-reports align with current financial reporting standards and makes the decision-making of investors more convenient (Bernow et al., 2019). Through the proposed ESRS, the EFRAG attempts to overcome the lack of comparability and lack of materiality-based ESG-reporting, which are two of the largest barriers for using ESG-data in investment decisions (Jonsdottir et al., 2022).

Chapter 3 Research methods

This exploratory thesis has researched the investors' perspective on ESG-reports through conducting semi-structured interviews as data collection method to ensure the capture of all relevant data within the interviews. To fully comprehend the research methods of this thesis, the sampling and selection methods (3.1), operationalising of ESG subtopics (3.2), detailing the qualitative data collection process (3.3), and explaining the data analysis methods that led to the findings (3.4) are addressed in this chapter.

3.1 Sampling and selection

A distinction between institutional and retail investors has been made, due to the different nature of these investors. Retail investors are non-professional investors who operate individually, institutional investors are organisations that invest on behalf of others. This study has focused on institutional investors as they often have more capital, exert a more significant influence on the market and are more experienced than the average retail investor (Bushee, 2004). Participants were recruited through desktop-research, followed-up with contact messages through e-mail addresses and LinkedIn. Desktop-research consisted of researching different institutional investor types, LinkedIn searches regarding these types and an open request on the writer's LinkedIn profile. A total of 16 interviews were conducted, with participants coming from different backgrounds working for different institutional investor types. The institutional investors that were interviewed preferred to be anonymous, therefore the names and institutions are not published. However, to get a better understanding of the interviewees, the institutional investor types are listed in *Table 3.*. To get a full understanding of the interviewees, a brief description of the institutional investors is given in *Appendix 2.*

Table 3. **Interviewees sorted by institutional investor type.**

Interviewee #	Institutional investor type	Interviewee #	Institutional investor type
Interviewee 1	Bank	Interviewee 9	Regional Development Agency
Interviewee 2	Bank	Interviewee 10	Wealth management
Interviewee 3	Pension Fund	Interviewee 11	Investment fund
Interviewee 4	Pension Fund	Interviewee 12	Investment fund
Interviewee 5	Venture capital	Interviewee 13	Investment fund
Interviewee 6	Venture capital / Regional development agency	Interviewee 14	Investment fund
Interviewee 7	Venture capital / Regional development agency	Interviewee 15	Investment fund
Interviewee 8	Regional Development Agency	Interviewee 16	Investment partner

Source: Author.

3.2 Operationalisation of ESG subtopics

The proposed key information is adopted from the ESRS proposed by the EFRAG. This key information needs to be included in ESG-reports for all undertakings that fall under the CSRD. The 15 defined subtopics (see *Table 2*) derived from literature have been operationalised in *Table 4.*

The three topical ESG are divided in 15 subtopics. The operationalisation of these subtopics is based on the ESRS. The EFRAG uses around 1,100 datapoints in the published drafts (SER, 2023). It is not feasible to use all these datapoints in the operationalisation of the ESG subtopics within the timeframe and capabilities of this thesis. Therefore, this study has used the published ESRS drafts to extract their main objective and gather 1-4 datapoints per ESG subtopic. This operationalisation can be observed in *Table 4.*

The operationalisation of these ESG subtopics has been used in the interviews held with investors, to give them more insight in the ESG subtopics and their specific information goals. This list is also used to find out whether institutional investors ask SMEs for additional key information within the ESG subtopics.

Table 4. **Operationalisation of ESG subtopics.**

# ESG subtopic	# Operationalization of ESG subtopic
E1 Climate change	Disclosure of Green House Gas (GHG) emissions Transparency on the impact on the climate and their hazards
E2 Pollution	Disclosure of pollutants in air, water, and soil Transparency on the financial effects of pollution Transparency on action-plans towards zero pollution
E3 Water & marine resources	Disclosure of water & marine resources usage Transparency on action-plans towards less water & marine resources usage Disclosure of impact on water & marine resources Transparency on action-plans towards less impact on water & marine resources
E4 Biodiversity & ecosystems	Disclosure of impact on biodiversity & ecosystems Transparency on action-plans towards less impact on biodiversity & ecosystems Provision of strategy towards no biodiversity & ecosystems loss
E5 Resources & circular economy	Disclosure of resource use and their waste Transparency on negative impact of resource use Transparency on the financial effects of their resources use Provision of strategy towards circular practices and minimizing waste
S1 Own workforce	Transparency on working conditions of own workforce Transparency on equal treatment and opportunities in workforce Transparency on work-related rights of own workforce (e.g., child labour)
S2 Workers in value chain	Transparency on working conditions of workers in value chain Transparency on equal treatment and opportunities in value chain Transparency on work-related rights of workers in value chain (e.g., child labour)
S3 Affected communities	Transparency on impact on communities' economic, social, and cultural rights Transparency on impact on communities' civil and political rights Transparency on impact on particular rights of indigenous communities'
S4 Customers & end-users	Transparency on information-related impact on customers and end-users Transparency on personal safety of customers and end-users Transparency on social inclusion of customers and end-users
G1.1 Corporate culture	Transparency on code of conduct mechanisms Provision of appropriate measures after rule violation
G1.2 Procurement management	Transparency on integration of ESG within supply-chain Provision of strategy for relationships with suppliers
G1.3 Prevention and detection of corruption/bribery	Transparency on prevention and detection mechanisms/policies in place Provision of anti-corruption/bribery trainings
G1.4 Confirmed incidents of corruption/bribery	Transparency on incidents of corruption/bribery Provision of appropriate measures after detection of corruption/bribery
G1.5 Engagement to exert political influence and lobbying activities	Transparency on the activities related to political influence and lobbying
G1.6 Payment practices	Transparency on payment practices

Source: Author, adapted from the ESRS.

3.3 Procedure

Due to the exploratory nature of this thesis, qualitative data collection is most suitable (Blumberg et al., 2014). The investors' perspective on sustainability and the key information of ESG-reports has been researched through the analysis of qualitative, primary data gathered through interviews. By using semi-structured interviews as the data collection method, answers to the influence on investors' decisions have been received while the interviewees were still able to add possible key information that was not derived from literature. This guaranteed the most precise and complete answers to the research questions.

Fourteen of the sixteen interviews were conducted via Microsoft Teams. Two of the sixteen interviews were held at an investors' office in Amsterdam. After receiving consent for recording the interview, the participants were informed about the academic background and the aim of the interview. The structure of the interview includes four different parts: the background of the interviewee and the organisation they work for (1), discussing possible institutional guidelines for SME investments, sustainability, and ESG-reports (2), a rank-order of the ESG subtopics (3) and a breakdown of the five most importantly ranked ESG subtopics (4). The complete interview structure and questions can be found in *Appendix 3*. Due to the semi-structured nature of the interviews, no interview was structured the same due to investor-specific conversations and follow-up questions. Nevertheless, all questions of the interview guide have been addressed in all sixteen interviews.

3.4 Analysis

To accurately provide answers to the second and third research questions, a deep understanding of the investors' perspective on sustainability and ESG-reports is required. Using the interview guide elaborated on in *Section 3.2,* interviewees have provided data for the data analysis. The analysis of the data was performed by making transcripts with automated Teams transcriptions in combination with manually making transcripts using the voice recording of two physical interviews. To extract results from the data, this thesis made use of two inductive coding techniques using the data analysis software 'ATLAS.ti' (Blumberg et al., 2014). In the first round of coding, quotations of interviewees were labelled with the following codes: 'Policy SME', 'Policy sustainability', 'ESG-analysis', 'Other analysis', 'ESG-analysis example', 'ESG-factors rank order', 'Specific ESG-data' & 'Legislation opinion'. These codes were then used to go into the second round of coding, making use of the axial coding technique (Blumberg et al., 2014). The quotations of the first round of coding were categorized in further detail with the second round of coding, creating new codes and sub-categories through inductive reasoning.

Eventually, a final list of 80 codes was created, which can be found in *Appendix 4.* Thereafter, the examination of patterns and themes in the final list of quotations and codes resulted in the exploration of answers to the research question.

Chapter 4 Findings and Discussion

In this chapter, the results of the data collection through the conducted interviews are presented and discussed. To logically structure the results, this chapter is divided in subchapters that correspond with the main topics discussed in the interviews. These subchapters were established in an inductive manner from the conducted interviews. Firstly, the different sustainability policies by institutional investors are discussed, to gain an understanding of the institutional investors' background and perspectives. Secondly, the existing analysis that investors use for their sustainable investment decisions are discussed, allowing a deeper understanding of the implementation of sustainability in the investment process. Thirdly, the investors' perspective on ESG-analysis and its key information is discussed to better grasp their perspective on the ESG-reporting and specific datapoints they look for. Fourthly, their views on the upcoming legislations are discussed, since they play a big role in their perspective and result in important discussion points for the CSRD and consequences for SMEs. Lastly, the implications for SMEs that lead from the findings will be discussed.

4.1 Sustainability policies

4.1.1 Themes and transitions

The data analysis uncovered that separate situations and business cases require different sustainability policies and assessments. Institutional investors acknowledged the unique characteristics and challenges associated with various investment opportunities. Consequently, they developed distinct policies and analyses to address the specific needs and risks of each investment decision. Institutional investors widely agreed that transparency by the SME is crucial in the investment process.

The sustainability policy most prominent in all institutional investors, was the exclusion of specific business sectors. All institutional investors mentioned having some form of restrictions in place for their investment decisions. Industries most mentioned were the weapon, gambling, fossil energy and the nuclear energy industries. If a business was operating in these sectors, they would not be considered an investment opportunity.

Another frequently mentioned distinct sustainability policy concerned the different themes and transitions regarding sustainability. Many institutional investors recognized the importance of addressing different focuses with different policies. The most frequently mentioned themes and transitions by the institutional investors were energy, food, circularity, digitalization, innovation, and resource use. The institutional investors would prioritise

investments in SMEs that operate in these themes and transitions, or even exclude SMEs who did not align with the sustainable mission of the investor.

Interviewee 14 – "We have three main impact themes where we invest in. It is sort of a positive selection where if they do not contribute to the themes they do not qualify."

The focus on specific themes and transitions can originate from self-made sustainability visions or policies made by governments. The findings on this matter did not differ between the various institutional investor types. However, they did differ between institutional investor size. Where the larger institutional investors founded separate analysis-teams and investment programs for distinctive topics, the smaller institutional investors exclusively focused on their selected topic. In general, smaller institutional investors had more focus on specific sustainability policies that align with their own business operations. For example, the regional development agencies were of a smaller size and focused mainly on their region and/or a specific business sector. Meanwhile, larger institutional investors showed that they possess more knowledge and resources to acquire more sustainability goals implemented in their core business. These large institutional investors have sustainability teams involved throughout the whole investment process, where sustainability is integrated in almost every part of their institution and corporate culture.

Interviewee 3 - "That is the philosophy that we have, sustainability only works if you do not only integrate it in documentation and products, but in the teams and people themselves."

4.1.2 Other alignments

Other than aligning sustainability policies towards specific themes and transitions, some institutional investors showed alignments with different policies and goals set by governments and the European Union. In particular, the Sustainable Development Goals (SDGs) set by the United Nations were frequently mentioned as drivers of sustainability policies for investments, with six of the sixteen institutional investors mentioning that within every SME investment some link with the SDGs is required. Related to this, some institutional investors mentioned aligning their sustainability policies and goals directly related to the Paris Agreement's goals and the 'Net Zero' policy set for 2030, where if investment options do not properly align, they would be removed from the investors' portfolio.

Interviewee 3 – "The only real targets that matter now are the Paris Agreement and Net Zero".

A significant factor that played a role in differentiating sustainability policies of institutional investors was not necessarily the size nor institutional type of the investor, but the origin of the investable money. All institutional investors still prioritised a valuable investment,

ensuring positive results for their clients. However, the institutional investors that invested with government funded money had larger focus on environmental goals set by those governments than on profitable goals, implying that all their investments were focused on impact. On the other hand, institutional investors that invested with private assets noted that sustainability was a lesser priority than profitability. In most cases, the goal was to incorporate both profitability and sustainability within every investment decision.

Interviewee 5 – "Impact investing and financial returns need to be able to go together."

In two of the sixteen cases, the institutional investor noted that they did not prioritise investing in sustainability matters at all. One of them was an investment partner, who noted that due to the small scale of SMEs, it is unfair to enforce rules on impact or sustainability on their chances of getting an investment.

Interviewee 16 – "You know what it is? As SMEs you are focused on survival and growth. If you get all kinds of rules imposed on you, it achieves the opposite and makes it more difficult to break out into the market."

The other case where sustainability was not a goal set in their policies, was with wealth management. They elaborated on the fact that their clients demanded profits, and the only way sustainability was considered was if it influenced the profitability of the investment.

Interviewee 10 – "Sustainability is a factor, not a goal. If ESG is an influential factor on the success of the investment, only then do we take it into account."

4.2 Sustainability analyses

Institutional investors employ various sustainability analyses in their investment decision-making processes. These analyses are driven by their corresponding sustainability policies discussed in *Section 4.1.*

4.2.1 Different types of analyses

Across the board, all institutional investors utilise situational-dependent analyses, which are tailored to specific contexts. These analyses can differ between materiality tests, linking investments to Sustainable Development Goals (SDGs), conducting life-cycle assessments, and other sustainability approaches. Notably, larger investors tend to have multiple sustainability analyses at their disposal, most of which are conducted by the investors themselves. Additionally, larger investors have the capacity to be more selective towards businesses, due to their large capital and many investing options. An example of an investment consideration is given by a large bank:

Interviewee 2 – "I have once rejected an investment application to build a new building which fully meets sustainability requirements and maybe a little better than that. However, the use of the building would be to rent it to an international transporting company, which would allow multiple trucks driving in and out of the building every day. Due to that reason, we did not follow up on the investment application. As you can see, we look deep into it."

On the other hand, smaller investors rely more on a single assessment, where the data is often less reliable and acquired from the investees. Adding to that, they have less credibility to deny investment opportunities with harsh measures. An example case from a smaller investment fund is given:

Interviewee 14 – "One case where we are looking at right now is a follow-on investment within the same business. We have given notice that some sustainability points need improvements, or otherwise we might not be following on with the investment. That way, we can put some pressure on the case."

In addition to their own analyses, some institutional investors refer to external ratings and labels as part of their evaluation process. This indicates their consideration of external assessments to evaluate the sustainability performance of potential investments.

Data for sustainability analyses are sourced in different manners. Smaller institutional investors may request SMEs to provide data themselves to perform their analyses. However, this approach has its limitations, as the information provided may not always be reliable or aligned with investors' preferences. For instance, most investors prefer quantifiable data, which many SMEs cannot accurately provide. Therefore, some smaller institutional investors mentioned not always being able to do thorough sustainability assessments of their investments. Alternatively, larger institutional investors have the resources, manpower and knowledge to directly assess SMEs themselves, which provide more accurate and reliable investment analyses. In most cases, investors prefer reliable, comparable, and verifiable data of quality, which corresponds with articles from the literature review performed in *Section 2.6.*

Once sustainability analyses are conducted, institutional investors undertake various approaches based on the results. These include engagement with the company to drive improvements in sustainability performance, pressuring firms to enhance their sustainability practices themselves or utilising traffic-light methods, where red indicates a no-go, orange implies engagement or a 'come back later'-request, and green signifies approval. However, one institutional investor noted that giving a no-go to an investment option is not necessarily always the most impactful decision.

Interviewee 3 – "Let's say that we remove some firm from our investment portfolio, because they do not align with the Paris Agreement. What happens then, is that investors that have no sustainability policies will pick up on that investment. We have then reached zero impact, while we did reject the investment. It might have been better if we started talking with the firm and possibly moved them in the right direction."

4.2.2 ESG-analyses

Fifteen of the sixteen institutional investors mentioned having some considerations regarding ESG-factors within an investment decision. Only the investment partner mentioned not having any involvement with ESG-factors, due to their perspective on not forcing all kinds of sustainability practices on SMEs. However, not all ESG-analyses are performed in the same manner. Larger institutional investors have the capacity and capital to perform more extensive ESG-analyses, considering many factors and being strict on multiple layers of ESG-factors. Smaller institutions emphasized on only considering factors that align with their transition, theme, or policy goals. A regional development agency provided this example:

Interviewee 9 – "If we invest in for example a business specialized in water-sensors, we would be looking completely differently than when a business is creating software-tools for investment funds. You cannot apply the same analysis on every case, you must look at every proposition individually on how to analyse and measure the impact."

The interviewees showed wide usage of ESG-factors within institutional investment decisions. The data collection for ESG-analyses is like the abovementioned sustainability analyses, where differences occur between the size of the institutional investor. In the case for ESG-analysis however, even larger investors acknowledge the fact that SMEs cannot address all factors due to their business size and therefore will not mandate all factors. Additionally, the follow-up measures based on the ESG-analysis results differ per investment decision and institutional investor. The various approaches based on ESG-analysis results are similar to other analysis, including engagement with the company, pressuring firm to enhance and utilizing the traffic-light method.

4.3 Specific key information

As mentioned before, fifteen of the sixteen institutional investors deal with some form of ESG-analysis and ESG-factors, with many variances between institutional investor types. Differences in the consideration of ESG-factors were often caused by the SME's size, the SME's industry, the investor's size, and the investor's sustainability policies. To best grasp the data collected, specific key information must be looked at per ESG topic individually.

4.3.1 Environmental

The ESG subtopics derived from the proposed ESRS for ESG topic 'Environmental' were 'climate change', 'pollution', 'water & marine resources', 'biodiversity & ecosystems' and 'resources & circular economy'. Not all institutional investors analysed all environmental subtopics within investment decisions, but every institutional investor showed engagement with at least one E-factor. Climate change was significantly valued as the most urgent E-factor.

Interviewee 1 – "I think that climate change is on top of the list, due to it being in top priority and the most acute. It is the one factor with the most impact within a short timeframe, we need to do something about that quickly."

Specific key information institutional investors look at within climate change, are the greenhouse gas emissions. In specific, CO2 was mentioned as most important greenhouse gas emission, with many institutional investors wanting to reach net zero within their investment portfolio. Another important greenhouse gas was nitrogen gas due to the strict nitrogen legislation in the Netherlands. Most institutional investors looked at scope 1 emissions, where the larger institutional investors were able to investigate further towards the whole value chain, including scope 3 emissions.

Institutional investors valued pollution highly as well, often referring to the linkage with climate change. Within pollution, the focus was on the usage of clean energy sources. Investment options using fossil fuels were in almost all cases rejected, due to strict exclusion policies. Larger institutional investors like banks and pension funds set benchmarks of specific energy labels for businesses, buildings, or projects that they were involved in. Many regional development agencies mentioned investing in SMEs or projects with solar panels and windmills, to increase the amount of green energy and restrict the amount of pollution within their regions.

Water & marine resources was seen as relatively unimportant with only one institutional investor, a regional development agency, mentioning overfishing as an important value in their sustainability agenda. Many institutional investors linked water & marine resources to the

impact on biodiversity & ecosystems. Not one institutional investor mentioned something on the amount of water and marine resources usage of the SME.

Impact on biodiversity & ecosystems contained a lot of situational dependency within investment options. Regional development agencies valued impact on biodiversity & ecosystems highly, where many investments carried out regional activities that could harm or positively impact the mentioned E-factor. Institutional investors capable of analysing the whole value chain focused on matters like deforestation, biodiversity footprints and specific land of origins of the product throughout the whole value chain.

Interviewee 3 – "To give an example, we use satellite screening and biodiversity footprint analyses to map the problems in the value chain and see where deforestation occurs. This way, we can start the conversation with the local producers to eventually steer them in the right direction."

A frequently mentioned comment involved the situational dependency of investments, where impact on biodiversity & ecosystems was only relevant when the SME in question operated in a relevant sector.

One of the most often mentioned sustainability policy of institutional investors was focused on the transition towards a circular economy. The institutional investors with green- and impact funds mentioned assessing data points like the amount of resource use, what material is used, recyclability and circularity. More specific, institutional investors mentioned looking for specific strategies and plans to reduce the resource use, increase the recyclability, create end-of-life solutions, and investigate the options for circularity. Resources & circular economy was something most investors could not avoid assessing due to the impact on the environment.

4.3.2 Social

The ESG subtopics derived from the proposed ESRS for ESG topic 'Social' were 'own workforce', 'workers in value chain', 'affected communities' and 'customers & end-users'. 'Own workforce' and 'workers in value chain' were valued highly within the social topic. Institutional investors stated that social factors were more difficult to assess, since the lack of quantifiable data on the matter. Additionally, many social factors currently rely on subjective opinions, where no general consensus is reached on sustainability levels of these social factors. Key information within social factors were diversity and inclusion, equal treatment, and opportunities, working conditions and the overall rights of the workers.

Interviewee 1 – "A good example is of a firm operating in the electric vehicle business, which is something that adds sustainable value to the world. However, their workforce was not treated well, where labour unions were actively opposed. That made us decide not to invest in that specific firm."

Significant exclusions in the value chain were revolved around the overall rights of workers in and outside of the value chain. These exclusions were child labour, labour in developing countries with harsh circumstances and forced labour. Not all institutional investors were capable of analysing workers in the complete value chain due to lack of capital and power, lack of verifiable information and not all investment options being involved in value chains. Some institutional investors mentioned SME-specific analyses, due to SMEs often having a smaller workforce which creates difficulties in supporting diversity and inclusion.

Many institutional investors acknowledged that affected communities is something sustainable SMEs must deal with and is thus deemed important in ESG-analyses. Especially regional development agencies valued affected communities, due to their regional sustainability policies and goals. SMEs involved in solar parks, windmill parks and other practices were assessed on impact on communities thoroughly. Institutional investors acknowledged that they wanted to see strategies and plans from investment options that display their awareness of affected communities. Sound pollution was often mentioned as one of the driving data points that is paid attention to.

Surprisingly, no institutional investor mentioned analysing customers & end-users. This might have occurred due to the focus of social factors on SME themselves, and not the end-product they deliver. However, when presented with the option to value customers & end-users, it was never prioritised, and no key information was provided.

4.3.3 Governance

The ESG subtopics derived from the proposed ESRS for ESG topic 'Governance' were 'corporate culture', 'procurement management', 'prevention and detection of corruption/bribery', 'confirmed incidents of corruption/bribery', 'engagement to exert political influence and lobbying activities' and 'payment practices'. Institutional investors widely acknowledged that governance factors within ESG-analyses were more difficult to analyse within SME investments due to the verifiability of data and the relevance for smaller businesses. *Interviewee 14 – "I just imagine that a business with around 10 workers is less involved in corruption scandals. Additionally, I personally think that SMEs cannot have much influence on political activities."*

Evaluating corporate culture differed between institutional investors. Some mentioned not analysing it for SMEs at all, while others mentioned that their judgement on corporate culture came from their impressions of the board and management. Corporate culture was seen as something that is not clearly reportable, but something that requires judgement and good agreements to have positive impact. Institutional investors requested assurance from managements, in combination with a clear strategy and vision for the SME.

Procurement management was a G-factor institutional investors did assess within ESG-analyses, where the main data points consisted of transparency on suppliers and the involvement of sustainability in the supply chain. Due to current relevancy, a frequently mentioned point of interest was the evaluation of possible ties to Russia, which would lead to a direct exclusion of investment opportunity.

Both factors involving corruption and bribery were seen as significant red flags. Either institutional investors mentioned that they did not analyse these G-factors since SMEs would already be rejected in their first set of screening if it occurred, or they would mention that SMEs would be directly dropped if an incident of corruption and/or bribery would occur. Prevention and detection measures were appreciated, but not assessed because SMEs were seen as small enough to not often be involved in cases of corruption and/or bribery.

Regional development agencies valued SMEs' engagement to exert political influence and lobbying activities more than other institutional investors, due to the ties these regional development agencies have with local politics and governments. Other institutional investors mentioned not really paying any attention to this matter, due to the (in their opinion) insignificant influence of SMEs on politics and lobbying. One larger institutional investor did mention that this G-factor was underexposed and appreciated more transparency on this factor. Mainly because the funding of SMEs can be directly linked to their relations with external parties, which could contain unsustainable connections.

Payment practices was another G-factor that institutional investors did analyse within investment decisions. The main demands were full transparency of payment practices, going as far as to see bank statements. If occurrences of dirty money, money laundering or unfair pricing occur, institutional investors would immediately decide to reject the investment decision. Another important demand of institutional investors was to have insights in strategies for payment practices of SMEs. One of the most important parts in a successful investment is the SME becoming profitable, increasing the investment value. All institutional investor types agreed on the fact that if no transparency or strategies were present regarding payment practices, they would place large doubts in the SME and possible investment offers.

4.3.4 Prioritisation of ESG-factors

Investors recognize that not all ESG-factors can be given equal weight in their decision-making process. As mentioned before, the prioritisation of ESG-factors depends on several key considerations, including the business model of the SME, the sector it operates in, and the size of the business being considered for investment. In fourteen of the sixteen interviews, all ESG-factors were mentioned to be in some form important, but the relative significance and impact of each factor may vary depending on contextual factors. In some cases, there can be overlap between different ESG-factors, and the weakness in one area may overshadow strengths in others, making prioritisation even more complex.

One of the significant elements that influences the prioritisation of ESG-factors are the specified purpose the investment fund is given by the institutional investor. Banks, pension funds, regional development agencies, venture capital and the investment funds all possessed multiple investment portfolios, with the investments focused on different specific themes or transitions. For example, an investment fund mentioned having different investment portfolios with separate ESG-factor prioritisations per portfolio. The investment portfolio focused on energy transition valued 'pollution' over other environmental factors, while the portfolio directed towards circularity deemed the 'resources & circular economy' factor as most valuable. This displays the variability in prioritisation of ESG-factors of the investors.

Interviewee 5 – "It is quite difficult to rank order the ESG-factors, because we have three different investing themes. It is not that we rank climate change more valuable than biodiversity, we use them as different focus points within investing themes."

Nevertheless, there were some general patterns to be observed in the prioritisation of ESG-factors. Institutional investors put significant focus on environmental factors above social and governance factors for SMEs. 'Climate change', 'pollution' and 'resource use & circularity' were ESG-factors deemed as one of the most important for all institutional investor types. Other significant ESG-factors valued highly throughout all institutional investor types were 'own workforce' and 'workers in value chain', specifically due to diversity and inclusion policies. Additionally, the presence of 'prevention and detection of corruption/bribery'-mechanisms was deemed as crucial, due to the strict no-go policies in place for incidents of corruption/bribery. Specifically for SMEs and the corresponding size of investment, governance factors like 'corporate culture' and 'engagement to exert political influence and lobbying activities' were overall valued as least important of all ESG-factors.

Next to the general patterns, some specific patterns within institutional investor types were observable. Regional development agencies showed great interest in the impact on

‘affected communities’, while other institutional investor types did not prioritise on that S-factor. Larger institutional investors, mainly banks and pension funds, acknowledged the importance of the social factor ‘workers in the value chain’. Mainly international SMEs were assessed strictly on their impact within the value-chain, looking at multiple ESG-factors. Venture capital, investment funds, asset management and investment partners prioritised the G-factors ‘procurement management’ and ‘payment practices’ over other institutional investor types. With two main reasons being that SMEs often need to focus on financial stability to become a stable business and the fact that when financial management within these SMEs are not on par the investor does not value it as a worthful investment.

4.4 Investors’ perspective on CSRD

The introduction of the CSRD and the upcoming regulations on ESG-analyses have elicited various opinions among institutional investors. To fully understand the investors’ perspective on ESG-analyses and their prioritisation of key information, it is important to gain knowledge on the investors’ perspective on the CSRD and its impact, with the benefits and the limits that come with the legislation.

Institutional investors recognize several positive impacts of the CSRD legislation on their investment practices. The institutional investors with green and impact funds specified that the introduction of sustainability reporting for SMEs can lead to better judgement of future-proof investments. By mandating sustainability reporting, the CSRD promotes the integration of long-term sustainability considerations into investment decisions. Additionally, investors predict that due to upcoming legislation, ESG-reporting will have better accessible data, increases transparency towards investment decisions and will enhance the ability to compare potential investments. These predictions correspond with the barriers and challenges investors experience mentioned in the literature review in *Section 2.6.* The predictions institutional investors made signal a positive response to the ESG-reporting legislation, due to the hopes that the investment decision making process will become more convenient. Another positive aspect mentioned by investors, is the fact that due to these reporting legislations, SMEs will incorporate sustainability within their business models from the beginning. This fosters sustainable growth and ensures that sustainability is integrated within the core operations of these businesses, ensuring more impactful investments for the institutional investors.

Despite acknowledging the benefits, institutional investors are very critical on new laws regarding ESG-reporting. Smaller institutional investors often face resource constraints, making it more challenging for them to assess all datapoints within ESG-reports. Larger

institutional investors have the capacity to aid the SME within this process, possibly creating an imbalance between institutional investors categories. Additionally, due to stricter regulations the ESG-reports will encompass a broader range of sustainability aspects, which can be complex to grasp and implement fully. Smaller institutional investors might experience trouble to effectively analyse and interpret the vast amount of information and thus make the investment process more time, resource and knowledge consuming. Certain ESG-factors, particularly those within the social domain, can be challenging to quantify and analyse.

Interviewee 12 – "For example, an unequal man/woman ratio is difficult to reject within an investment decision. If you want to invest in a hairdressing business, chances are that more women will work there due to it being preferred by women more than men. It would be harsh to reject an investment option due to that unequal man/woman ratio."

Some institutional investors argued that the legislation places a disproportionate emphasis on social aspects driven by political agendas. Furthermore, differences in cultural norms, opinions, and perspectives may impact the consistency and reliability of reported sustainability data. Another concern on the reliability of the reported data is that some companies may focus more on disclosing policies rather than demonstrating actual outcomes, leading to ESG-reporting being used as a marketing tool.

Ultimately, institutional investors acknowledged the fact that they too require adaptation to new legislations like the CSRD, which makes the investment process more complex and time consuming.

4.5 Implications for SMEs

Based on the data collected from the interviews with institutional investors, several implications can be drawn for SMEs when implementing ESG-reporting. To start off, it is crucial for SMEs to understand and consider the varying sustainability policies of institutional investors. The data revealed that institutional investors have different policies regarding sustainability and ESG-reporting, with a focus on themes and transitions, exclusion of specific business sectors, and alignment with external goals such as the SDGs and the Paris Agreement. SMEs should carefully analyse these policies and align their ESG-reporting efforts with the themes and transitions that are prioritised by the institutional investors they seek to attract, or approach institutional investors that have sustainability policies aligned with their specific business case.

Furthermore, institutional investors undertake different sustainability analyses, including different ways of ESG-analyses in their investment decision-making processes.

Differences were mainly found between the size of the institutional investor. Larger institutional investors may perform ESG-analyses and assess data themselves which could benefit SMEs with limited resources but comes with the cost of stricter analyses and more ESG-factors considered. On the other hand, smaller institutional investors often prioritise ESG-factors that align with their own transition, theme, or policy goals. SMEs should tailor their ESG-reporting to address the relevant ESG-factors for each investor they target. Regional development agencies clearly showed interest in regional sustainable businesses, with clear priorities in environmental focuses and the social factor 'affected communities'. SMEs operating in specific regions or sectors can align their ESG-reports with the institutional investor group that prioritises their region or sector.

Moreover, the data indicated that engagement and dialogue between institutional investors and SMEs can be valuable in driving improvements in sustainability performance. Institutional investors emphasized the importance of initiating conversations with SMEs and guiding them towards sustainable practices, rather than simply rejecting investment options. SMEs should actively seek opportunities to engage with institutional investors, showcase their commitment to sustainability, and demonstrate a willingness to improve their sustainability practices based on feedback and guidance.

Within reporting ESG-data, SMEs should mainly focus on the datapoints mentioned in the CSRD legislation. There was little to no extra key information that institutional investors asked for, that is not included in the ESRS. Institutional investors brought up no new points of key information but did specify individual operationalised ESG subtopics. For example, in the ESRS, the disclosure of GHG-emissions is requested key information in the 'climate change' ESG subtopic. Institutional investors also requested GHG-emissions from SMEs, but specifically put focus on the GHG-emissions in the form of CO2 and nitrogen. Another example is the ESG subtopic 'own workforce'. The ESRS mentions equal treatment and opportunities in the workforce, but institutional investors mainly fixated on diversity and inclusion in the workforce. Specifying reported information within ESG-reports can aid SMEs in their attractiveness towards institutional investors.

Furthermore, the data highlighted the importance of transparency of SMEs in the investment process. Institutional investors emphasized the need for reliable, comparable, and verifiable data to perform sustainability analyses. SMEs should ensure that their ESG-reporting includes as much quantifiable data as possible and addresses the key information within the ESG-factors the institutional investor prioritises. By providing comprehensive and reliable data, SMEs can enhance their chances of attracting investment from institutional investors.

Chapter 5 Conclusion

5.1 Conclusion

This research project has contributed to the knowledge gap mentioned in *Chapter 1,* by exploring and identifying the key information that investors look for in the ESG-reports of SMEs. This contribution has been made through addressing the following central research question and its sub-research questions:

'*How can SMEs implement ESG-reporting to differentiate themselves towards investors?*

1. *'What are the main challenges SMEs face related to ESG-reporting?'*
2. *'What do investors value regarding sustainability?'*
3. *'What is the requested key information investors look for in SMEs ESG-reports?'*

The main challenges that SMEs face related to ESG-reporting can be summarised to key challenges SMEs face while implementing sustainability practices. These challenges consist of a lack of knowledge, mainly due to not understanding the benefits, the need to hire costly third parties, making investments in staff expertise and acquiring scientific and technical knowledge. Secondly, these challenges consists of a lack of resources, specifically the limited amount of staff, the restricted amount of time available, the lack of stakeholder engagements and the limited budget/capital SMEs have. Thirdly, specific sustainability implementation challenges due to a changing management structure, the lack of suitable reporting tools and the dependency on a single manager. Moreover, SMEs face specific challenges related to ESG-reporting. Existing ESG-reporting tools and guidelines are focused on larger businesses, making them incompatible and complex to implement for SMEs. Additionally, SMEs lack the resources and knowledge for ESG-reporting techniques and acquiring specific key information on some ESG-factors. The CSRD attempts to provide SME-specific standard for ESG-reporting, which is the most relevant bridge to overcome the multiple implementation challenges SMEs face.

Looking at the investors' perspective on sustainability, we can see that institutional investors have company-specific visions and policies on the matter. Different investment opportunities require different sustainability policies and assessments. In general, smaller institutional investors had more focus on specific sustainability policies that align with their own business operations. Meanwhile, larger institutional investors showed that they possess more knowledge and resources to acquire more sustainability policies implemented in their whole core business. Specific themes and transitions, such as energy, food, circularity, digitalization, innovation, and resource use are important focus areas for institutional investors

and their policies for investment decisions. Some institutional investors align their sustainability policies with governmental policies and goals, including the Sustainable Development Goals (SDGs) and the Paris Agreement's goals. The origin of investable money also plays a role in differentiating sustainability policies, with government-funded investors prioritizing environmental goals and private asset investors prioritizing profitability alongside sustainability.

Institutional investors have different ways of performing ESG-analyses and thus varying methods of requesting key information in ESG-reports. Most notably, requested key information varied due to the size, business model and sector of the SME. Institutional investors emphasized the need for reliable, comparable, and verifiable data to perform sustainability analyses. Not all ESG-factors can be given equal weight in the institutional investors' investment decision-making process. Environmental factors are generally prioritized above social and governance factors by institutional investors, most noticeably the factors 'climate change', 'pollution' and 'resource use & circularity'. There were some specific patterns regarding the prioritisation of ESG-factors observed within institutional investor types. Larger institutional investors acknowledged the importance of the impact within the whole value-chain. Regional development agencies showed great interest in the impact on 'affected communities', while other institutional investor types did not prioritise on that S-factor. Institutional investors investing with private assets prioritised the G-factors 'procurement management' and 'payment practices' over other institutional investor types. Institutional investors highlighted the importance of transparency for SMEs in the investment process. Within the reporting of ESG-factors and their requested key information, institutional investors did not ask for additional key information other than the datapoints included in the ESRS drafts. Some institutional investors did specify some ESG subtopics to more narrow requested key information, but it was always within the scope of the ESRS drafts.

To successfully implement ESG-reporting to differentiate themselves towards institutional investors, SMEs should consider the varying sustainability policies of institutional investors. To differentiate towards institutional investors, SMEs can actively seek institutional investor types that focus on their specific business case. Aligning ESG-reporting efforts with the themes and transitions prioritized by institutional investors can be beneficial. SMEs should focus on datapoints included in the ESRS drafts, staying as transparent as possible. It is important to focus on environmental goals while keeping social and governance factors on at least a minimal level required by institutional investors. In the end, the key is to offer both profitability and sustainability towards the institutional investors.

5.2 Limitations

This study experiences some limitations. To begin with, this thesis builds upon the ESG topics provided in the draft European Sustainability Reporting Standard (ESRS). However, the final ESRS will be published in the summer of 2023. The ESG topics and subtopics might experience some adjustments in the final publication which could result in new subtopics that have not been discussed in this research. This does not make this research invalid, because the ESG topics are backed up by other sources besides the ESRS. Additionally, this thesis attempts to explore the field and the perspective of the investors, and not necessarily test the ESG topics derived from literature.

To gather the most relevant data to answer the research questions, a focus on a specific type of institutional investor would have led to more reliable results. However, due to the limited time frame of this thesis and the ability to contact a limited number of institutional investors, this thesis makes use of all institutional types. To overcome this bias, this thesis has focused on diversity of institutional investors within its sampling and selection, to gain a more diverse and complete overview of the institutional investors' perspective. Another limitation derived from this timeframe challenge was the fact that not all institutional investors invested in the same type of SMEs; some only in listed, some in non-listed SMEs, and some in both. This can imply that institutional investors provided answers with different investing situations in mind and thus challenging the validity of the findings.

With the interviews being semi-structured, a challenge to the reliability is formed. A semi-structured interview leaves room for interpretation and deviations by the interviewee and interviewer. To cope with this issue, an interview guide was created and can be found in *Appendix 3.* In this guide, the order of the questions is defined and stays in line with the conceptual framework. By doing so, the interviewer can keep control of the ESG subtopics that will be discussed and make sure the interviewee does not deviate much in their answers. Additionally, due to the relevancy of the sustainability topic, social desirability bias can occur in the interview where the investor might give desirable answers towards ESG topics. To overcome this, the interview did start with an introduction explaining the importance of honest answers and assuring anonymity.

This researched has focused on exploring the world of ESG-reporting by SMEs. However, the qualitative data collection method was targeted at the investors' perspective exclusively. The perspective of SMEs has only been considered in the literature review of this thesis, with limited unique insights in the SMEs' perspective. There has been no data collection done on the SMEs' perspective, limiting the explorative range of this study.

5.3 Recommendations

To give structure towards future research, this thesis will introduce propositions for future research, derived from the conclusion paragraph above.

Proposition 1: SMEs face different challenges when implementing ESG-reporting practices.

Future research can explore these challenges in greater depth, investigating the root causes and potential solutions. This can involve performing a case-study where SMEs are followed in their ESG-reporting process. Additionally, comparative studies can be conducted to analyse the challenges faced by SMEs across different industries and regions.

Proposition 2: Institutional investors value ESG-reporting in SMEs and seek specific key information.

Further research can delve into the specific ESG-factors that institutional investors prioritize and examine how they vary across different investor types. It would be valuable to investigate the reasons behind the different weighting given to ESG-factors and their impact on investment decisions. Comparative studies across various institutional investors and SME types can provide valuable insights.

Proposition 3: Transparency and comprehensive ESG-reporting enhance SMEs' chances of attracting investments.

Future research can explore the impact of transparency and comprehensive ESG-reporting on the investment decisions of institutional investors. This can involve examining the specific data points and metrics that institutional investors find most influential and exploring ways to standardize and improve the comparability of ESG data. Longitudinal studies can assess how SMEs ESG-reporting influence their investment attractiveness over time.

Proposition 4: Tailoring ESG-reporting to investor preferences enhances SMEs' attractiveness towards investments.

Research can focus on understanding the varying sustainability policies and preferences of different institutional investors. Investigating the alignment between ESG-reporting efforts of SMEs and the sustainability themes, transitions, and goals prioritized by institutional investors can be valuable. Future studies can explore the impact of targeted ESG-reporting strategies on attracting investment from specific types of institutional investors.

By exploring these propositions, future research can contribute to a deeper understanding of the challenges and opportunities for SMEs in ESG-reporting. This study is a pivotal piece in closing the knowledge gap regarding ESG-reporting for SMEs. Future research should consist of building upon this study, focusing on specific exploratory propositions addressed in this thesis.

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Appendices

Appendix 1: SWOT Analysis Framework for Potential Environmental Sustainability Issues (Shields & Shelleman, 2015).

Opportunities	Threats
•Cust. dem. associated with valuing sustainability •Evolving customer demand for sustainable operations, products, or services •Revenue generating products/services that address sustainability concerns of existing customers •Revenue generating product/service extension to assist customers in reducing their env. impacts •New market segments to target with sustainable products/services •Sustainability branding in key lines of business, including first mover advantage •Comp. not competing based on sustainability brand •Regulation (lack of or pending) •Stakeholder demand for change •Supply chain competitive sourcing •Material cost reductions •Emerging technologies	•Cust. lack of awareness and/or commitment •Competitors' sustainable products/services/operations •Competition branding itself based on environmental impacts, including "green wash" •Insufficient gov. incentives and/or fin./investors to facilitate inv. in eco-efficient processes •Regulation (lack of or pending) •Value chain partners demand sustainable oper. •Stakeholder resistance to sustainability •Difficulty attracting and retaining talented workers who value sustainability •Potential shortages in key resources/inputs •Key resources/inputs facing dramatic price increases and/or price volatility •Rising energy costs •Unanticipated syst. economic and sociopolitical impacts of climate change, water shortages, etc
Strengths	**Weaknesses**
•A sustainability strategy is in place •Executives and owner(s) committed to sustainability •Employees value sustainability •Have taken actions to innovate at improving environmental performance •A company history of proactive strategic choices •Experience mapping processes •Risk management capabilities •Knowledge base & structured process(es) for plan. •Good understanding of stakeholder and customer preferences for sustainability •Roles and responsibility for sustainability allocated and clearly communicated •Strong comp. mission and history based on ethical serv., comm. responsibility, and long term effects •Organization and culture supports innovation and cross disciplinary collaboration •Indirect org. capabilities in sustainability •Well-developed information systems, performance measurement and reporting •Resource base is robust	• No sustainability strategy • Lack of commitment from managers/owner(s) • Lack of/low commitment from employees • Business case for sustainability is not apparent • No current hist. & track record of actions taken • Knowledge base and capabilities for sustainability readiness planning are weak • Poor understanding of how stakeholders and customers value sustainability • Poor or no formal allocation of responsibility for sustainability initiatives and outcomes. • Heavily dependent on ecologically unsustainable processes • Company culture places low value on innovation • Few, if any, systems for performance measurement and reporting • Lack of infrastructure for working with suppliers • Facing other significant competitive challenges associated with resource constraints
Sources: Avram & Kuhne (2008), Bagur-Femenias et al. (2013), Baumgartner (2009), Brammer et al. (2012), Bonini & Bove (2014), Bos-Brouwers (2010), CIMA (2011), CGMA (2014), Clarkson et al. (2011), Ernst & Young (2013), GRI (2013), Heras & Arman (2010), Hoogendoorn et al. (2015), Hower (2013), Jasch (2009), Kiron et al. (2013), Klewwitz & Hansen (2014), KPMG (2013), Lawrence et al. (2006), Leonidou et al.(2014), Loucks et al. (2010), Lumpkin et al. (2010), Revell et al. (2010), The Economist Intelligence Unit (2008), Williamson et al. (2006), Woods & Joyce (2003), Zorpas (2010).	

Appendix 2: Institutional investor types

Interviewee 1:

- A large financial institution focused on sustainable banking and investments.
- Aims to support projects and initiatives that have a positive impact on society and the environment.

Interviewee 2:

- A large sustainable bank that provides banking, investment, and asset management services.
- Focuses on financing businesses and organizations that promote social, cultural, and environmental sustainability.

Interviewee 3:

- A large pension fund management company that manages pension assets on behalf of various organizations, including two larger pension funds.
- Committed to responsible and sustainable investment practices.

Interviewee 4:

- A large pension fund management company that manages pension assets on behalf of various organizations, including two larger pension funds.
- Committed to responsible and sustainable investment practices.

Interviewee 5:

- A venture capital dedicated to creating positive social and environmental impact through innovative solutions.
- Works with businesses, governments, and organizations to develop and implement sustainable strategies.

Interviewee 6:

- A regional development agency that focuses on stimulating economic growth and innovation in the Eastern Netherlands.
- Supports entrepreneurs and businesses in various sectors, including renewable energy and sustainable technology.

Interviewee 7:

- A regional development agency that focuses on stimulating economic growth and innovation in the Eastern Netherlands.
- Supports entrepreneurs and businesses in various sectors, including renewable energy and sustainable technology.

Interviewee 8:

- A regional development agency in the province of Limburg, Netherlands.

- Promotes economic development by providing support, financing, and expertise to innovative businesses.

Interviewee 9:

- A regional development agency in Utrecht, Netherlands.
- Promotes economic development by providing support, financing, and expertise to innovative businesses.

Interviewee 10:

- A large wealth management firm focusing on optimal return on investment.
- Offers tailored investment solutions that align with clients' financial goals and values.

Interviewee 11:

- An investment fund that promotes sustainable energy and advises on renewable energy projects.
- Works with businesses, governments, and communities to accelerate the transition to clean energy sources.

Interviewee 12:

- An investment fund that promotes sustainable energy and advises on renewable energy projects.
- Works with businesses, governments, and communities to accelerate the transition to clean energy sources.

Interviewee 13:

- A regional investment fund in North Holland, Netherlands.
- Provides financing and support to innovative companies and projects in various sectors, including sustainability and technology.

Interviewee 14:

- An investment fund focusing on sustainable investments and financial solutions.
- Invests in and supports innovative ventures in sectors such as sustainable energy, circular economy, and cleantech.

Interviewee 15:

- An investment fund focusing on sustainable investments and financial solutions.
- Invests in and supports innovative ventures in sectors such as sustainable energy, circular economy, and cleantech.

Interviewee 16:

- An investment partner firm specializing in government funding and grants.
- Assists companies in accessing funding opportunities for innovative and sustainable projects.

Appendix 3: Interview guide

Background of the interviewee

First, the background of the interviewee was discussed. To gain a clear profile of the interviewee, the following questions have been asked:

1. Could you explain what kind of work you do and who you work for?

Policies towards SMEs and sustainability

To understand the vision of the institutional investor, the interviewee was asked to give insights on institutional guidelines on SME investments, sustainability policies and ESG-reports.

2. Do you have institutional guidelines concerning SME investments? If so, what?
3. Do you have institutional guidelines concerning sustainability? If so, what?
4. Do you have institutional guidelines concerning ESG-reports? If so, what?

Rank-order of ESG subtopics

To gain insight on the most important key information that investors look for in ESG-reports, the ESG subtopics that arose from the literature review have been proposed to the interviewee. The interviewee received physical or online cards with all 15 ESG subtopics included in the ESRS drafts. The interviewee was then asked to rank them from 1 (most important) to 15 (least important).

5. Can you rank these 15 ESG subtopics from most important to least important?

Breakdown of five most important ESG subtopics

After the interviewee had produced a ranking of the 15 ESG subtopics, this study sought to find a reasoning behind the prioritisation of ESG subtopics that have been ranked. Questions were asked about the operationalised ESG subtopics and the vision of the interviewee towards them. Specifically, more information about the five most important ESG subtopics has been requested, which allowed the interviewee to elaborate more on the reasoning behind the prioritisation of specific ESG subtopics and providing key information points.

6. Why did you rank the chosen ESG subtopics as the five most important?
7. What specific information do you look for in ESG subtopic ranked as 1?
8. What specific information do you look for in ESG subtopic ranked as 2?
9. What specific information do you look for in ESG subtopic ranked as 3?
10. What specific information do you look for in ESG subtopic ranked as 4?
11. What specific information do you look for in ESG subtopic ranked as 5?

Appendix 4: Final list of codes after axial coding.

1. Policy SME
2. Policy sustainability
    a. Profit-based
    b. Exclusions
    c. Theme's
    d. Transitions
    e. Strict requirements
    f. SDG-link
    g. Paris/Net-zero
    h. Mission/vision
    i. Labels/certification
    j. Fund-specific
    k. Low priority
    l. Difficult implementation
    m. Undecided
3. ESG-analysis
    a. Full analysis
    b. Situation-dependent analysis
    c. Sanctions
    d. Process
    e. Prioritisation
    f. Positive influence
    g. No implementation
    h. Engagement
    i. Undecided
4. Other analysis
    a. Traffic-light method
    b. SDG
    c. Paris agreement
    d. Net-zero
    e. MVO-policy
    f. Materiality test
    g. Life-cycle assessment
    h. Automatized
    i. Engagement
    j. Undecided
5. ESG-analysis example
    a. Exclusions sector
    b. Sentiment
    c. Pressure on sustainability
    d. Innovation focused
    e. Sustainable energy
    f. Corruption scandals
    g. Farmers
    h. Affected communities
6. ESG factors rank order
    a. Environmental
    b. Social

    c. Governance
    d. Situation-dependency
    e. Rank order
    f. Positive selection
7. Specific ESG-data
    a. Environmental
        i. Climate change
        ii. Pollution
        iii. Water & marine resources
        iv. Biodiversity & ecosystems
        v. Resources & circular economy
    b. Social
        i. Own workforce
        ii. Workers in value chain
        iii. Affected communities
        iv. Customers & end-users
    c. Governance
        i. Corporate culture
        ii. Procurement management
        iii. Prevention and detection of corruption/bribery
        iv. Confirmed incidents of corruption/bribery
        v. Engagement to exert political influence and lobbying activities
        vi. Payment practices
8. Legislation opinion
    a. Subjectivity
    b. Spectrum narrowing
    c. Scale of business
    d. Profit-oriented
    e. Politics
    f. Marketing
    g. Generalisation
    h. Data availability