# Mediating Effect of Corporate Social Responsibility on the Relationship between Corporate Governance and Financial Constraints: Evidence from Sri Lanka

**Weerasinghe, K.D.T.N.**

*Department of Accounting and Finance, Faculty of Management and Finance, University of Ruhuna, Sri Lanka*
*thanya@mgt.ruh.ac.lk*

***Abstract***

*This study investigates whether better Corporate Governance (CG) would lead to mitigate Financial Constraints (FC) and how Corporate Social Responsibility (CSR) mediates this relationship in companies listed in Colombo Stock Exchange of Sri Lanka. Additionally, this study aims at assessing the degree of CG, CSR and FC of the listed companies in Sri Lanka. The population that has been taken for this study is public listed companies in Colombo Stock Exchange (CSE) as at 31st March 2017 and 100 companies were selected as the sample based on the highest market capitalisation excluding banking, finance and insurance and investment trusts sectors due to its' inherent nature of being highly regulated and use of financial statements which are different from other companies. Descriptive statistics were used to assess the degree of CG, CSR and FC; regression analysis was taken to examine the direct relationship between CG while FC while Sobel-Goodman Test was taken to examine the mediation effect of CSR on the above direct relationship between CG & FC. Results depict that degree of CG and CSR does not have a significant deviation from the findings of the local studies. Additionally, a negative relationship was investigated between CG and FC. Finally, the study concludes that a mediation effect of CSR does not exist on the direct relationship between CG and FC. This study will contribute to the extant literature by investigating the relationship between CG and FC with the mediating effect of CSR as empirical studies that were silent about the mediating effect of CSR to the above direct relationship.*

***Keywords:*** *Financial Constraints, Corporate Governance, Corporate Social Responsibility*

# 1. Introduction

In majority of financial research, the ways by which organizations make investment decisions in a financially constrained environment has been highlighted as a fundamental question (Almeida & Campello, 2007). These FC exist in imperfect capital markets due to informational asymmetries and agency costs (Cheng et al., 2014). CG and CSR are means by which agency cost and informational asymmetries are reduced. A company will operate in interest because of its investors and further non-investing stakeholders through its CG and CSR practices (Mahrani & Soewarno, 2018). As a result, firms utilize these concepts and theories to mitigate the likelihood of negative environmental, political, and fiscal changes (Hillman & Keim, 2001; Berman et al., 1999; Freeman, 1984).

CG and CSR should not be considered in isolation due to the reason that a company's CG mechanism will not be entirely effective if it does not consist of a sustainable CSR drive (Jamali, Safieddine & Rabbath, 2008). Good Social Responsibility promotes better stakeholder performance, stakeholder engagement (Cheng et al., 2014) and long-term quality relationships with investors (Gras-Gil, 2016). As a result of lower FC faced by an organization (Cheng et al., 2014), it facilitates cheaper equity financing (El Ghoul et al., 2011) and reduces cost of bank debt (Nandy and Lodh, 2012). Accordingly, there is a notable relationship between CG and CSR (Khan, Siddiqui and Muttakin,2013; Jamali, Safieddine & Rabbath,2008; Beltratti, 2005) and there is evidence that CSR is associated with lower FC (Cheng et al., 2014). Based on these facts, this study examines whether CG contributes to lower FC and raise the question if there is a mediating role of CSR which impacts the relationship between CG and FC of a firm.

## 1.1. Problem Statement and Research Questions

Ho (2005) depicts CSR as a dimension of CG which means that better CSR can be attributed to a good CG. Similarly in Bhimani and Soonwalla (2005) model, the relationship between CG and CSR have been taken as part of a continuum. Naturally, legal requirements of CG draw more attention compared to voluntary CSR performance (Jamali, Safieddine & Rabbath, 2008). Nevertheless, CSR is increasingly desired as CG and CSR as a part of the same continuum (Bhimani & Soonwalla, 2005). When considering the relationship of these variables to FC, studies argue better CG (The world bank, 2016) and CSR (Cheng et al., 2014) lead to lower FC and thereby better access to finance. This study expands on these relationships by combining the variables CG, CSR and FC. The main objective of this study is to examine whether better CG would lead to lesser FC and how better CSR mediates on that relationship. The research questions of the study are as follows;

1. What is the degree of corporate governance, corporate social responsibility and financial constraints?

2. Is there any direct relationship between corporate governance and financial constraints?

3. Is there any mediation effect of Corporate Social Responsibility on the above direct relationship between corporate governance and financial constraints?

## 2. Literature Review

### 2.1. Corporate Governance, Corporate Social Responsibility and Financial Constraints

Talamo (2011) has identified that majority of definitions related to CG is 'to control and provide supervision of the company, management or managerial conduct'. In regard to Sri Lankan context, Dissa Bandara (2016) states that the mean value of overall corporate governance score (CGS) in terms of board adherence in Sri Lanka is 165 out of 296. Manawaduge (2012) also provides a similar insight on degree of CG where the mean value of overall CGS is 61.17 indicating a 68% compliance rate. Accordingly, the actual CG practices in Sri Lanka are considerably deviated from the expected standard (Dissabandara,2016).

CSR is widely recognized as 'the social responsibility of business which encompasses the economic, legal, ethical and discretionary expectations that society has of organizations at a given point of time' Carroll (1979). In Sri Lankan context only 34% of the firms out of 232 firms has adopted CSR reporting (Fernando & Pandey, 2012). The CSR disclosure level is 64.77% when banking sector is isolated (Niresh & Silva, 2017). However in wider context, the CSR reporting levels are low (below 50%) except for a fewer number of companies (Wijesinghe, 2012).

According to Lamont et al., (2001) financial constraints can be broadly identified as frictions preventing firms from funding all projects they desire. Firms have constraints in obtaining finance which is a key barrier for growth (Malhotra et al., 2007). Further obtaining finance is a greater challenge for small firms than large firms. (Niranjala & Jianguo, 2017; Beck et al., 2002; Schiffer & Weder, 2001,).

### 2.2. Corporate Governance and Financial Constraints

Most of the earlier literature found that sensitivity of investment to free cash flow (to internal funds) increases in the organizations possessing feeble CG standards (Degryse & de Jong, 2006; Goergen & Renneboog, 2001; Cho, 1998). Lins et al., (2005) argues that if outside investors found that controlling shareholders expropriate corporate resources without restrictions by disregarding minority shareholders, they expect a high return and it causes an increase in cost of external funds compared to internal funds. Therefore, having a better corporate framework is important. It will provide benefits to firms through greater access to financing, lower cost of capital, better performance and better treatment to all stakeholders (Claessens & Yurtoglu, 2013).

## 2.3. Corporate Governance and Corporate Social Responsibility

CG and CSR, both concentrate on the moral practices in business and responsiveness of an entity to its wide stakeholders and the environment where it operates. Khan, Siddiqui and Muttakin (2013) emphasize that corporate governance indicators such as presence of audit committees and board independence have significant positive impacts on CSR disclosures of a firm. Further they emphasize that CG attributes play a vital role in ensuring organisational legitimacy through CSR disclosures. Beltratti (2005) argues that both CG and CSR practices are positively correlated with market value of the firm.

## 2.4. Corporate Social Responsibility and Financial Constraints

Literature up to date has expressed two contradictory conclusions regarding the ultimate result of engaging CSR activities. First set of studies argued that CSR results in increasing firms' cost unnecessarily and it does not create any value to business (Jensen, 2002; McWilliams & Siegel, 1997; Friedman, 1970). Second set of studies argued that benefits of CSR activities open the doors to valuable resources (Cochran & Wood, 1984), allowing firms to market their products effectively (Fombrun, 1996; Moskowitz, 1972), attracting consumers who are more socially conscious (Hillman & Keim, 2001), and attracting financial resources from socially responsible investors (Kapstein, 2001). Similarly, Eccles et al., (2011) show that superior CSR performance strengthens the cooperation and mutual trust between firm and stakeholder groups and forces managers to be long term oriented. As a result, it lowers the potential agency cost and consequently, it minimizes the expected returns of investors and increases firms' ability to take external funds. Accordingly, average firms with better CSR performance faces lower financial constraints (Cheng et al., 2014).

As stated, it is clear that there are studies that explore relationship between CG and FC, CSR and FC and CG and CSR. However, there is dearth of studies which examined relationship between corporate governance and access to finance with the mediating effect of corporate social responsibility. This study attempts to contribute to the existing literature and finds out how CSR would reduce the barriers to external finance as a mediator between corporate governance and access to finance especially in relation to a developing country like Sri Lanka.

## 3. Methodology

This research investigates whether there is a direct relationship between CG and FC with the mediating effect of the CSR in Sri Lanka. This study is based on a positivist paradigm (Cheng ,2014; Aldamen, 2012; and Fazzari, 1988). Accordingly, the hypothesis of the study are as follows

H1: Corporate governance is positively associated with financial constraints

H2: There is a mediating effect of corporate social responsibility in relation to corporate governance and access to finance

The population that has been taken for the study is all listed companies in CSE. From this, the top 100 companies in terms of market capitalization were selected after excluding companies functioning in banking, finance, insurance and investment trusts and companies which have financial year endings other than the year of 2017 (March 31). Provided that, published annual reports of 2 years (2016/17 & 2017/18) of top 100 listed companies in the CSE categorized under 18 sectors have been selected. Both financial and non-financial data available in annual reports such as corporate governance and corporate social responsibility aspects have been used.

### 3.1. Operationalization

The independent variable and the mediating variable, CG and CSR were measured using a content analysis and a supporting scoring system. A checklist was prepared including dimensions and subdimensions under CG and CSR. The dimensions in the CG index include directors, director's remunaration, institutional investors and other investors, accountability and audit, relations with share holders and sustainability reporting whereas dimensions of CSR index include employee welfare, customer, shareholder, social, environment, product and government. A binary scoring system was used to measure the level of CG and the level of CSR.

Taking into account,in measuring CG, scoring is based on the existence of items and each dimension is equally weighted. If an item in the checklist is disclosed, a score of 1 is awarded, if not, 0 is awarded. Then number of items disclosed is divided by the maximum possible score to get the Corporate Governance Index (CGI). On the contrary, CSR disclosures were given scores,sentence wise (Hackston & Milne, 1996) due to the reason that coding is likely to provide meaningful, reliable and complete data for analysis (Milne & Adler, 1999). Finally company wise, score will be calculated by total scores of each category of each firm afterwards, same as in measurement.

In accordance with the empirical evidence, FC are said to be ambiguous, as there is a dearth of direct measures which everyone agrees upon. However, KZ index has been extensively used as a measure of FC in corporate finance literature. (Hong et al., 2012; Baker et al., 2003: Lamont et al., 2001). KZ index is a relative measurement of reliance on external financing (Kaplan & Zingales, 1997). Companies which own a higher KZ-Index score are likely to experience more financial constraints when accessing finance. Further, KZ –index was originally developed for non-financial firms. Therefore, it justifies the index for this study as the study is not focused on financial firms. Therefore, in this study, KZ index will be used to measure the main dependent variable measure financial constraints. The index is based on five-factor model as mentioned below;

KZ Index = [- 1.001909 x Cash Flows / K] + [0.2826389 x Q] + [3.139193 x Debt / Total Capital] + [-39.3678 x Dividends / K] + [-1.314759 x Cash / K]

Cash flows = (Income before Extraordinary Items + Total Depreciation and amortization), K= $PPE_{t-1}$, Q= (Market Capitalization + Total Shareholder's Equity - Book Value of Common Equity - Deferred Tax Assets) / Total Shareholder's Equity, Debt = Total Long-Term Debt + Notes Payable + Current Portion of Long Term Debt, Dividends = Total Cash Dividends Paid, Cash = Cash and Short-Term Investments

Table 1: Variables, Working Definitions & Measurements

| Variables | Denotation | Working Definition | Measurement |
|---|---|---|---|
| | | *Independent variable* | |
| Corporate Governance | $CGI_{it}$ | Corporate Governance is mechanisms, processes and relations by which corporations are controlled and directed (Shailer 2004). | CGI index (SEC & CA, 2013; Aldamen & Duncan, 2012a; Chen et al., 2009; Doidge et al., 2007; Durnev & Kim 2005) |
| | | *Mediating variable* | |
| Corporate Social Responsibility | $CSRI_{it}$ | The social responsibility of business encompasses the economic, legal, ethical and discretionary expectations that society has of organizations at a given point of time (Carroll 1979). | CSRI index (Khan,2016; Chan, Watson & Woodliff, 2013; Ntim & Soobaroyen, 2013 Haron, 2009; Turker, 2009) |
| | | *Dependent variable* | |

| | | | |
|---|---|---|---|
| Financial Constraints | $KZI_{it}$ | The wedge between internal and external costs of funds (Kaplan & Zingales 1997). | KZ index (Hong et al., 2011; Lamont et al., 2001; Kaplan & Zingales 1997) |
| | | *Control Variables* | |
| Firm Size | $FSIZE_{it-1}$ | Firm Size is the size of a particular firm in terms of total assets for a particular period. | The natural logarithm of total assets at the beginning of the year (Ilaboya & Ohiokha 2016) |
| Growth | $GOS_{it}$ | Growth of Sales the amount a company derives from sales compared to a previous period. | [Sales $_t$ – Sales $_{t-1}$] / Sales $_{t-1}$ |
| Profitability | $FROCE_{it}$ | The ability of given investment (or firm) to earn a return from its use (Nishanthini & Nimalathasan 2013). | Return on Capital Employed $_t$ |
| Leverage | $LEV_{it}$ | Leverage is the total liabilities scaled by total assets at the end of the year (Francis et al., 2013). | Total liabilities $_1$/ Total Assets $_{t-1}$ |
| Age | $FAGE_{it}$ | Age of the company since Incorporation (Ilaboya & Ohiokha 2016). | Firm age is the number of years since the incorporation of the company (Ilaboya & Ohiokha 2016) |
| Cash Flows | $CF_{it}$ | Cash flows are the sum of earnings before depreciation and amortization. | Earnings $_t$ + Depreciation $_t$+ Amortization |

### 3.2. Analysis Startegy

To determine the level of CG, CSR and FC , descriptive statistics will be used. Measures of central tendency has been used in the study which were conducted by Hussainey and Aljifri (2012); stated by, Zainuddin and Haron (2009)and further which are related to the concepts of FC, CG and CSR. To assess the direct relationship between CG and FC, regression analysis will be conducted (Aldamen and Duncan, 2012; Hussainey and Aljifri, 2012). The regression model will be as follows;

$$\begin{aligned} KZI_{it} = \alpha + \beta_1 CGI_{it} + \beta_2 FSIZE_{it} + \beta_3 SEC_{it} + \beta_4 GOS_{it} + \beta_5 FROCE_{it} + \beta_6 LEV_{it} \\ + \beta_7 FAGE_{it} + \beta_8 CF_{it} + \varepsilon \end{aligned}$$

In order to assess the mediation effect of corporate social responsibility on the above direct relationship between CG and FC, Sobel-Goodman test will be utilized. In mediation analysis, the Sobel test (Sobel, 1982) is usually a commonly used method to analyse the mediating effect. It is used to calculate the extent to which the mediator carries the relation between the independent variable and the dependent variable (Chang, Yu & Hung, 2015). Hayes process Version 3.4.1 for SPSS was used for mediation analysis of this study (Hayes, 2017).

$$\begin{tikzcd} CGI_{it} \arrow[r] \arrow[rr, bend left] & CSRI_{it} \arrow[r] & ATF_{it} \end{tikzcd}$$

## 4. Findings and Discussion

Table 2: Descriptive statistics

| Variable | Minimum | Maximum | Mean | Median | Standard Deviation |
|---|---|---|---|---|---|
| CGI | .4000 | .8933 | .7216 | .7466 | .1081 |
| CSRI | .0204 | .8980 | .4091 | .4081 | .2644 |
| *KZI** | -114.01 | .5900 | -28.98 | -4.84 | 47.030 |

*Due to the presence of significant outliers, winsorized version of 15% has been considered for descriptive analysis and also other analyses depicted, in regression analysis and Sobel Goodsman test.

In analysing the level of corporate social responsibility disclosure in Sri Lanka, CSR index shows a compliance mean value of 40.91%. This compliance rate conforms with the study of Wijesinghe (2012). A mean compliance rate of 72.16% was found in assessing of the degree of corporate governance in Sri Lanka. There is no significant diviation in the mean compliance rate compared with the findings of Dissabandara (2016) and Manawaduge (2012). When statistics of KZI is observed, it's clear that there is a significant variation across the quoted public companies regarding to financial constraints. Sri Lanka has a better level of KZI compared to the findings of Cheng et al., (2014). However, KZI in Sri Lanka is subjected to a broader level of variation when compared with previous studies.

Table 3: Regression Analysis

| *Variable* | *Bi* | *T* | *Sig* |
|---|---|---|---|
| CGI | -.655* | -2.158 | .032 |
| GOS | 4.779 | .821 | .413 |
| FROCE | -41.715 | -1.853 | .055 |
| FSIZE | -.508 | -.336 | .738 |
| LEV | .061 | .529 | .598 |
| AGE | -.133 | -1.511 | .132 |
| CF | -.002** | -3.787 | .000 |
| Constant | 39.865 | 1.291 | .198 |
| Adj. R2 | | .136 | |
| *F Value* | | 4.331 | |
| *Sig* | | .000 | |
| *Dependent Variable: KZI* | | | |

The above regression output shows that a negative relationship exists between CGI and KZI. Similary the correlation analysis highlighted a negative association between the two variables (r=-.213, n=200, p=0.02). In addition, there is a negative and a significant relationship between control variable CF and KZI. However, rest of control variables have a non-significant effect on KZI.

Table 4: Mediating effect of CSR

| | *Effect* | *T* | *LLCI* | *ULCI* | *P* |
|---|---|---|---|---|---|
| Total effect of CG on KZI | -.9256** | -3.0660 | -1.5210 | -.3303 | .0025 |
| Direct effect of CG on KZI | -1.1714** | -3.3810 | -1.8547 | -.4482 | .0009 |
| | *Effect* | | *BootLLCI* | *BootULCI* | |
| Indirect effects of CG on KZI CSR | .2458 | | -.1280 | .6729 | |
| Level of confidence for all confidence intervals in output: 95% | | | | | |

LLCI-Lower Level Confidence Interval, ULCI-Upper Level confidence Interval, BootCI-Bootstrap confidence intervals

Literature shows that ( Degryse & de Jong, 2006; Goergen & Renneboog, 2001; Cho, 1998) the sensitivity of investment to free cash flow increases among the organizations which has lower investor protection. Therefore it was confirmed that better governance would lead to lesser FC, in connection with prior studies. This study discovered the same link between the variables which is an inverse relationship between CG and FC. Hence it can be concluded that CG is negatively associated with FC as the above findings denote a negative and a significant regression between CGI and KZI. It is believed that when the level of compliance of CG increases, it impacts the level of KZI to decrease which would ultimately affect the enhancement in the level of Access to Finance.

The indirect effect in Table 4 is tested using non parametric bootstrapping. The bootstrapped unstandardized indirect effect is .2458, and the 95% confidence interval ranged from -.1280,.6729. Thus the indirect effect is statistically insignificant. This implies the indirect effect (mediating effect of CSR) performs an insignificant role in the relationship between CG and FC. However, when it comes to the direct effect (relationship between CGI and KZI), there is a significant negative relationship between CG and FC. Hence, it is possible to conclude that there is no mediating effect of CSR among the relationship between corporate governance and financial constraints.

## 5. Conclusion

Corporate governance and corporate social responsibility have become widely discussed topics in Sri Lankan context. Today, corporate governance practices are popular in the world as well as in Sri Lanka as it enhances the capability of firms to minimize agency dilemma and to lessen financial constraints. Although many research has been carried out in this area, it was found that there are lack of studies that emphasize the direct relationship between corporate governance and financial constraints with the mediating effect of the corporate social responsibility.

The findings of the study manifested the degrees of corporate governance and corporate social responsibility conforming with previous local findings. The degree of access to finance had significant variation across the sample but the overall result showed lesser financial constraints in firms. One of the reasons for this could be the selection of a sample based on highest market capitalization basis. However, such need is vital to be further investigated. Based on the results of the study, a negative relationship exists between corporate governance and financial constraints. As per the final objective, the findings of the study denoted that a mediation effect of CSR does not exist in between corporate governance and financial constraints.

This study has come across several limitations such as limiting the sample to 100 listed companies in CSE excluding banking, finance, insurance and investment trust companies, sole use of secondary data and the dearth of literature existing between three-party relationships among the variables: corporate governance, corporate social responsibility and access to finance. Thus, these limitations together with the findings of the study provide future research directions such as, reasoning out of why corporate social responsibility does not mediate in relationship between corporate governance and financial constraints. However, this study will contribute to extant literature by investigating the relationship between corporate governance and financial constraints with the mediating effect of corporate social responsibility.

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