# Does Sustainability Reporting Affect the Financial Performance? Evidence from Companies in Consumer Services Industry on Colombo Stock Exchange

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## A B S T R A C T

There is no clear evidence on how sustainability reporting affects financial performance. Further, only a few studies have investigated the relationship between sustainability reporting and financial performance in the Sri Lankan context. Therefore, this study explored how sustainability reporting affects financial performance using data from the most recent six years, from 2015 to 2020, collected from the published annual reports of 35 companies listed under the consumer services industry group of the Colombo Stock Exchange. Sustainability reporting was measured using 40 criteria relating to general, economic, environmental, and social GRI G4 guidelines. Return on equity was used to measure financial performance, while the firm size and firm age were measured using market capitalization and the number of years from the initial listing respectively. The pooled OLS regression model was used to analyze the data. The results indicate a significant relationship between sustainability reporting and financial performance. General Disclosure Average Index, Economic disclosure Average Index, firm size, and firm age have positive relationships with financial performance. Based on this study, stakeholders and shareholders are able to make their decisions related to sustainability reporting in the Sri Lankan context. Moreover, future research can focus on the formulation of a contextually relevant sustainability reporting index.

***Keywords:*** Colombo stock exchange, Financial performance, Global reporting initiative, Return on Equity, Sustainability reporting

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# 1. Introduction

Sustainability reporting has become prominent with the implementation of international financial reporting standards (Asuquo et al., 2018). Sustainability reporting was proposed to measure and report the environmental and social impacts that arise with the business practices (Atu, 2013). According to Pramanik (2008), factors such as government, stakeholders' pressure, and regulatory standards affect sustainability reporting. A firm should properly disclose the positive and negative effects of their business activities on the environment and society in their sustainability reports (Aggrawal, 2013). In addition, the inability to report sustainability would create ethical issues for a company (Dastane & Amacha, 2017).

A positive association between sustainability reporting and financial performance is well-established in the literature. According to stakeholder theory, sustainability reporting helps firms to improve financial performance by increasing the number of customers, sales margin, and investments (Bayoud, 2012). According to Dastane & Amacha (2017), companies that follow sustainability reporting have shown higher financial performance than companies that do not follow sustainability reporting. Moreover, sustainability reporting is negatively associated with equity capital costs, and this negative association can be seen strongly in the countries that are more stakeholder-oriented (Dhaliwal et al., 2014). Companies should adhere to sustainability reporting to achieve long-term corporate growth, efficiency, financial performance, and competitiveness.

The positive effect of sustainability reporting has been denied by some literature (Buys et al., 2011; Eccles et al., 2009). This can be due to the increased operating costs associated with sustainability reporting. According to agency theory, though managers receive private benefits from sustainability reporting, a company, as a whole, experiences a lower financial performance (Eccles et al., 2009). Disclosing indirect economic impact, social impact and environmental impacts of a firm over the period does not create any impact on the return on equity and return on assets (De Silva, 2018).

Importantly, most of the studies on this topic have been conducted in foreign contexts. Since the contextual setting is substantially different in Sri Lanka, such studies conducted abroad fail to elaborate on the relationship between sustainability reporting and financial performance in Sri Lanka. Therefore, this study aims to identify the effect of sustainability reporting on the financial performance of firms in Sri Lanka based on the evidence from listed companies in the consumer services industry. Hence, this study assesses the relationship between sustainability reporting and financial performance using a more recent dataset on 35 firms listed in the Colombo Stock Exchange under the consumer services industry group (CSE) using four sub-indices to measure sustainability reporting.

# 2. Literature review

Environmental reporting, consumer reporting, community involvement reporting, and employee-related reporting improve a firm's financial performance (Bayoud, 2012). Many firms have faced the pressure of having corporate accountability for legal, social, economic, and environmental aspects from their stakeholders (Waddock, 2004). Firms with a higher degree of sustainability reporting are more long-term oriented and these firms tend to disclose both financial information and non-financial information related to the environment, governance, and society (Eccles et al., 2009). Further, according to stakeholder theory, sustainability reporting and financial performance have a positive relationship, as firms with higher sustainability reporting are more likely to pursue a mutual agreement with their stakeholders and make the company more profitable (Eccles et al., 2009). Moreover, disclosing social issues is negatively associated with the cost of equity capital. This negative association is more visible in counties with more stakeholder orientation (Dhaliwal et al., 2014).

According to agency theory, the companies with greater sustainability reporting practices have greater financial performance and growth than other companies. Based on high and low institutional ownership, only low institutional ownership companies should follow sustainability reporting, because lower institutional ownership shows financial performance improvements in the year after reporting (Whetman, 2018). Adopting environmental and social policies increases the agency cost and this may lead to a decrease in the shareholders' wealth. Though managers receive private benefits by adopting sustainability reporting, a company as a whole may experience a lower financial performance (Eccles et al., 2009). According to Aggrawal (2013), there is no association between sustainability reporting and financial performance.

Dastane & Amacha (2017) stated that companies that follow sustainability reporting practices have shown higher performance when compared to the companies that did not follow sustainability reporting practices, based on the triple bottom line theory. The adoption of environmental and social policies is considered a luxury practice by the consumers and with this, firms are able to increase their profits. The influence of corporate social practices positively affects ROA, and this shows that sustainability reporting positively affects a firm's profitability (Laskar, 2019). Based on the financial reporting theory, Murray et al., (2005) stated that social and environmental performance disclosures do not significantly affect financial performance, because sustainability reporting is just an operating expense for the firm. As sustainability reporting ensures that a company's business activities are conducted according to societies' respective boundaries and norms, companies are able to promote their brands and products to target societies and earn more returns over market competitors (Asuquo et al., 2018).

## 3. Methodology

This study investigates the effect of sustainability reporting on the financial performance of listed companies in the consumer services industry group in Sri Lanka. Of the 37 companies listed on the Colombo Stock Exchange as of 30$^{th}$ June 2021 under the consumer services industry group, 35 companies were selected for the sample while two companies were dropped due to unavailability of annual reports. Data was collected from annual reports over six years, from 2015 to 2020. Sustainability reporting was measured using 40 sub-criteria out of the total 145 in the GRI G4 index. These forty sub-criteria were classified into four categories and then four sub-indices, namely, General Disclosure Average Index (GDAI), Social Disclosure Average Index (SDAI), Environmental Disclosure Average Index (EnDAI), and Economical Disclosure Average Index (EcDAI) were constructed. A binary coding system that assigned "1" for presence and "0" for the absence of reporting criteria is used to measure sustainability reporting (Laskar, 2019). Return on equity was used to measure a firm's financial performance (Lassala et al., 2018). Firm size and firm age were used as control variables and measured by the market capitalization and number of years elapsed since the firm was first listed in the CSE (Branco & Rodrigues, 2006; Laskar, 2019) respectively. The data was analyzed using the OLS regression model specified in equation (1).

$$ROE= \alpha+ \beta_1 GDAI+ \beta_2 SDAI+ \beta_3 EcDAI+ \beta_4 EnDAI+ \varepsilon \text{ --------(1)}$$

In equation (1), ROE represents the return on equity. α stands for the intercept. β represents regression coefficients for respective variables. ε Indicates the random error. The data set was tested for the assumptions of normality, linearity, multicollinearity, and independence. The outliers were identified with a boxplot. The Kolmogorov- Smirnov test was done to find out whether the data set has complied with the normality of residual assumption. To convert non-normally distributed data to normally distributed data the square root method was used. *VIF* values were used to test multicollinearity issues. Durbin-Watson test was done to test the independence assumption.

## 4. Findings and discussion

All companies included in the consumer services industry group are hotels that are directly related to the Sri Lankan tourism industry. Sri Lanka was known as the best tourism destination in 2018 and with the Sunday Easter attack, the performance of the industry dropped by 70 percent in 2019. Further, with the Covid 19 pandemic, the performance of the industry dropped again in 2020 (The Fortress Resort PLC, 2021).

**Table 1: Descriptive Statistics**

| | ***Symbol*** | **N** | **Min**[a] | **Max**[b] | **Mean** | ***SD***[c] |
|---|---|---|---|---|---|---|
| General Disclosure Average Index | GDAI | 204 | .73 | 1.00 | .90 | .09 |
| Economic Disclosure Average Index | EcDAI | 204 | .38 | .88 | .60 | .13 |
| Environmental Disclosure Average Index. | EnDAI | 204 | .00 | 1.00 | .29 | .24 |
| Social disclosure Average Index | SDAI | 204 | .00 | 1.00 | .52 | .35 |
| Log Market Capitalization | LMC | 204 | 7.41 | 10.56 | 9.08 | .63 |
| Firm Age | FA | 204 | 2 | 82 | 35.25 | 14.63 |
| Return on Equity | ROE | 204 | -20.28 | 18.72 | 1.75 | 7.25 |

Notes: SD, Min, and Max stand for standard deviation, minimum and maximum respectively

As illustrated in table 1, except for EcDAI, all other sustainability reporting indices suggest that some firms fully comply with these criteria. In other words, except for EcDAI, the three other sustainability reporting practices have been fully complied with at least in one year, by at least one company. The data suggest that sustainability reporting in the consumer services industry group has gradually increased. Most probably, this may be to manage risks effectively, compete in the market, achieve long-term profitability, improve communication with stakeholders, achieve reputation, and comply with reporting guidelines and government rules. Many firms have shown a negative return on equity. Most probably, this negative ROE is due to the economic collapse resulting from the Easter Sunday attack and Covid 19 pandemic.

Kolmogorov- Smirnov and Shapiro-Wilk test results have shown that the residuals of regression are normally distributed ($D$ (122) = .051, $p$=.20, $p$=18). Further, the observations have not met the independence assumption ($D$-$W$= 1.062). As *VIF* values in all variables are close to one and below five, the overall model indicated the absence of multicollinearity issues.

**Table 2: Regression Coefficients**

| Variable | Symbol | β | *t* | *VIF* |
|---|---|---|---|---|
| Constant | A | -62.381* | -6.483 | |
| General Disclosure Average Index | GDAI | 22.495* | 3.329 | 1.96 |
| Economic Disclosure Average Index | EcDAI | 13.735* | 3.689 | 1.191 |
| Environmental Disclosure Average Index | EnDAI | -2.492 | -0.838 | 2.602 |
| Social Disclosure Average Index | SDAI | -1.285 | -0.655 | 2.349 |
| Market capitalization | LMC | 3.808* | 4.432 | 1.458 |
| Firm age | FA | .070* | 2.233 | 1.074 |

*Notes:* ($R^2$ = .256, $F$ (6,197) = 11.29, $p$< .001).

* indicates statistical significance at 5%

As illustrated in table 2, the overall regression model was statistically significant ($R^2$ = .256, $F$ (6,197) = 11.29, $p$ < .001). Bayoud (2012) and Dastane & Amacha (2017) reported similar results, that sustainability reporting affects financial performance. However, this study does not agree with the studies that show sustainability reporting does not affect financial performance (Asuquo et al., 2018; De Silva, 2018).

As illustrated in table 2, among the sustainability variables, GDAI has a significantly positive effect on ROE (β= .286, $p$=.001). EcDAI also has a significant positive effect on ROE (β= .247, $p$<.001). However, other sustainability reporting indices, named EnDAI (β= -.083, $p$=.403) and SDAI (β= -.062, $p$=.513) did not show a statistically significant relationship with ROE. This study has shown similar results to the relationship between environmental and social sustainability reporting and financial performance in the Nigerian context (Asuquo et al., 2018). When considering the control variables, both firm size (β= .329, $p$<.001) and firm age (β= .142, $p$=.027) have shown positive effects on firm performance measured using ROE. Therefore, this study agrees with Bayoud, (2012); Laskar (2019) and Moore (2001) which argues that there is a positive effect of firm size and firm age on a firm's financial performance.

## 5. Conclusion and implications

Findings suggest that sustainability reporting is positively associated with the financial performance of firms in the consumer services industry group in Sri Lanka. Similar findings have been stated in most past literature as well. For example, according to the stakeholder theory, the firms which report sustainability practices regarding their external stakeholders, such as suppliers, society, government, creditors, shareholders, and customers, are associated with higher performance (Bayoud, 2012; Gauthier, 2005). In other words, better sustainability reporting leads to better financial performance (Dastane & Amacha, 2017; Laskar, 2019). More precisely, general disclosure and economic disclosure related to sustainability reporting are positively associated with a firm's financial performance. There is no significant relationship between environmental disclosure and social disclosure and financial performance. Nevertheless, since sustainability reporting in the Sri Lankan context is voluntary, the level of reporting is moderate. Further, the findings suggest that the larger firms have better financial performance than small and medium-sized firms. Moreover, older firms are more profitable in the consumer services industry group than younger firms. As one of the first studies to investigate the relationship between sustainability reporting and financial performance in consumer services industry group in Sri Lanka, the findings of this study provide most recent evidence from Sri Lanka related to the association between sustainability reporting and firm performance.

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