

## **The Relationship between Sustainability Reporting and Financial Performance of Listed Companies in Sri Lanka**

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### **Introduction**

In the modern business world, Sustainability Reporting (SR) is an essential but challenging subject which is considered to be important on a global scale (James, 2015). The concept of SR comprises of disclosure in three dimensions i.e. economic, environmental, and social. Therefore, SR can be referred to as a voluntary endeavor which involves publishing accounts that reflect economic, environment, and social performance of an organization (Isenmann & Kim, 2006). SR is the main platform of communicating the sustainability practices and corresponding impacts of a company to its stakeholders. Many developed countries disclose their sustainability practices (Dissanayake, Tilt and Xydias-Lobo, 2016).

On the contrary, there is a deficiency in sustainability reporting in developing countries. This is of special concern, since the majority of the world's population is predominately from developing countries and they are facing their own social and environmental problems on their own (United Nations, 2013). Even in Sri Lanka, SR has received relatively poor consideration compared to other developing countries, due to SR not being a mandatory reporting requirement in Sri Lanka (Peiris and Anise, 2019). Most companies adopt GRI framework in the reporting structure. This helps companies to move from either social or environmental based perspectives on sustainability to a progressively integrated view. Furthermore, adopting the GRI framework promotes clarity, accuracy, usefulness and comparability in sustainability reporting (Dissanayake, Tilt and Xydias-Lobo, 2016).

## **Objectives**

The main objective of this study is to explore the relationship between sustainability reporting and financial performance of listed companies in Sri Lanka.

## **Methodology**

The current study embraces a quantitative approach which uses secondary data to measure the relationship between sustainability reporting and firm-level financial performance. For this analysis, the study uses all two hundred and eighty-five (285) companies in the Colombo Stock Exchange (CSE), representing twenty different sectors for the study. As per the primary perusal, it was noted that, only eighty-seven (87) companies were following the GRI framework for SR in their annual reports which represent the total population of this study. Out of these, fifty-five (55) listed companies were selected through purposive sampling, based on researchers' criteria that annual reports should be prepared in compliance with the GRI framework and consecutively for the period 2015/16 to 2018/19.

Independent variable of this study is sustainability reporting, which consists of economic, social and environmental disclosures. The data related to these variables were gathered through content analysis based on G4 and GRI standards. Data was collected from the published annual reports of the companies in the sample for the period concerned and was then measured by deploying the SR index. To measure the dependent variable (i.e., financial performance) the study adapted the ratios of Return on Assets (ROA) and Return on Equity (ROE). The current study has used panel data for the process of analyzing the stated objective. Descriptive statistics and Pearson's correlation were computed to analyze the relationship between the SR and FP and the tests were conducted using STATA statistical package.

## **Sustainability Reporting Index**

SR Index is a measurement technique used to verify whether SR has been done in accordance with GRI framework. This measurement comprises of four (4) economic, twelve (12) environmental and thirty (30) social standards respectively, according to the G4 guideline. Whereas six (6) economic, eight (8) environmental and nineteen (19) social standards were recognized

according to the GRI standards (GRI, 2015). Each sub-variable was computed based on the standards adhered to by companies after measuring the total compliance of each component, which was then converted to a 100% scale using equation (1) (De Silva, 2019). This study used SR index as a composite variable to analyze sustainability reporting through the combination of economic, social and environmental disclosure.

$$SR\ Score = \frac{Amount\ of\ Compliance}{Number\ of\ Standards\ Considered} \times 100\% \quad (1)$$

### **Return on Assets (ROA)**

ROA is an indicator of efficiency of the firm relative to the total assets employed, which is given by equation (2):

$$ROA = \frac{Net\ Income}{Average\ Total\ Assets} \quad (2)$$

### **Return on Equity (ROE)**

ROE is a profitability measure that calculates the amount of profits earned as a percentage of the shareholders' equity, which is shown by equation (3):

$$ROE = \frac{Net\ Income}{Average\ Shareholders'\ Equity} \quad (3)$$

## **Results and Discussion**

The descriptive analysis demonstrates the objective and it derived basic characteristics of the present study data set as variability and distribution. The descriptive statistics of SR Index (independent) and dependent variables in the study, allows the researcher to describe data in terms of mean, standard deviation, minimum and maximum values and it provides basic summary of variables. In assessing the companies, researchers have found fifty-five companies (55) who report on sustainability according to the researchers' criteria for the period 2015/2016 –2018/2019 (four-year period).

Table 1 (in Appendix) shows that ROE has recorded a mean of 0.13 and standard deviation of 0.15 with a minimum of -0.44 and maximum of 0.93. The mean of ROA is 0.05, while the standard deviation is 0.07, with a minimum of -0.11 and a maximum of 0.39. Overall sustainability disclosures were indicated through SR Index which has a mean of 0.56 and standard

deviation of 0.20. In addition, social disclosure, an independent variable, has an average value of 0.53 and standard deviation of 0.20. Furthermore, other independent variables, environmental and economic disclosures, have 0.59 and 0.62 average values respectively. Economic disclosure shows the highest mean value of 0.62 among the variables and a standard deviation of 0.29 with a minimum of 0.17 and maximum of 1.

Further, the mean of the economic disclosure variable showed the highest indicated response in the data, while the ROA disclosure variable reported lowest response compared with other variables. According to the analysis, average values of dependent variables are 0.05 to 0.15. The independent variables' average values are maintained above 0.5. Due to the dispersion of data, economic disclosure is highly spread-out over a wide range and the ROA amount of variation is the lowest value.

**Correlation analysis** was carried out to measure the relationship between a company's FP and sustainability disclosures. Further, correlation indicates the strength of the linear relationship (positive or negative) of variables. Pearson correlation was calculated between the main variables (dependent and independent variable) and results reported in Table 2 (see Appendix).

The reported results show that economic (-0.00071) and social disclosure (-0.1343) is negatively correlated with ROA which indicates that there is a weak negative relationship at 5% level of significance and only environmental disclosure is positively correlated with ROA at a 5% level of significance which are tabulated in the table, depicting a weak positive relationship (0.0774) while being insignificantly correlated. This condition indicates that most of the companies provide sustainability reports as a form of environment disclosure to stakeholders to improve return on assets in the company by increasing recording environment disclosure. However, it indicates a negative relationship, by decreasing recording the economic and social disclosure to improve return on assets in the company.

The correlation coefficients between economic, environmental and social disclosures with ROE are respectively -0.0525, -0.1184 and -0.0286. Furthermore, correlation between SR index and ROA is -0.0604 while the correlation between SR and ROE is -0.0630. According to the outcomes of correlation matrix, by decreasing reporting sustainability disclosure will

enhance the Return on Equity in the company. It was also revealed that SR and ROE has no statistically significant correlation.

## **Conclusion**

The present study explores the relationship between SR and FP of the listed companies in Sri Lanka. SR index was used to measure the SR in accordance with GRI framework while ROA and ROE were used to measure financial performance for the period 2015/16 to 2018/19.

The study concludes that ROA has no statistically significant correlation with independent variables of SR except for the social disclosure variable, which showed a weak negative correlation with ROA in public listed companies. Furthermore, it was noted that all three variables in sustainability reporting revealed a negative correlation with ROE. It also identified SR of many publicly listed companies being negatively correlated with the ROE compared to ROA. As future research the study recommends that this phenomenon be further observed by increasing sample size and deploying other SR frameworks.

## **References**

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## Appendix

Table 1: Results of Descriptive Statistics

Variable	Obs	Mean	Std.dev	Min	Max
ROE	220	.1291818	.1511577	-.44	.93
ROA	220	.0530909	.0717205	-.11	.39
SR Index	220	.5614545	.2014959	.15	1
Social	220	.5362727	.2087836	.11	1
Environmental	220	.5965909	.268263	0	1
Economic	220	.6166818	.2872693	.17	1

Table 2: Correlation between SR and FP

	Eco	Env	Soc	SR_index	ROA	ROE
Eco	1.0000					
Env	0.3618*	1.0000				
Soc	0.6024*	0.5567*	1.0000			
SR_index	0.6955*	0.7621*	0.9460*	1.0000		
ROA	-0.0071	0.0774	-0.1343*	-0.0604	1.0000	
ROE	-0.0525	-0.1184	-0.0286	-0.0630	0.6794*	1.0000
	0.4381	0.0797	0.6734	0.3520	0.0000	

Note: \* represents significant at 5% level of significance.