Impact of Quality of Sustainability Reporting on the Financial Performance of Companies

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Introduction

The financial performance and financial information are linked with each other. Financial performance is recorded as financial information in the financial statements. Based on the financial information, the financial performance would be affected in the future. Financial analysts rely on financial information to analyse the financial performance and make predictions about the future direction of a company's share price. Based on the financial information, the stakeholders also make their financial decisions and it would affect the firm's future financial performance.

Over the past decades, reporting has evolved to meet the fluctuating needs of users. Public reporting has developed from disclosing only core financial data to including detailed information encompassing environmental, social and economic impacts of company operations and products, as well as other non-financial data. Firms all over the world are increasingly being challenged to expand and enlarge their financial reportage to include both those targeted at profiteering as well as social efforts being made to improve the environment. Hence, the sustainability reporting has emerged as a business philosophy and fast gaining momentum in this millennium especially in the phase of the adoption of International Financial Reporting Standards (IFRS) which emphasizes a lot on reporting and disclosure.

A sustainability report is an organizational report that gives information about economic, environmental, social and governance performance. Sustainability reporting is an extension of Corporate Social Responsibility (CSR) to include the environmental and economic dimensions instead of only social responsibility disclosures. It provides comprehensive sustainability details of a company and CSR now includes matters such as climate change, global warming, and animal rights, conservation of biodiversity and human rights as well as social equity.

The number of organizations that disclose information on their sustainability performance has increased considerably in recent years. According to the Governance and Accountability Institute Inc. (2012), 53 per cent of the 500 largest companies listed on the US stock exchange follow the S&P 500 (SPX) stock index-published sustainability reports, whereas 63 per cent follow the Global Reporting Initiative (GRI) indicators. A report published by KPMG (2013) indicated that nearly 93 per cent of the 250 largest companies around the world publish this type of report. This data demonstrates that sustainability reporting is now a common practice whose standardization improves with the increasing use of the GRI. Despite the differences in terms of sustainability practices between countries worldwide, the GRI provides a unified standard for sustainability reporting and, in principle, offers the possibility of comparing information, proceeding with benchmarking between various organizations and informing investors about corporate sustainability performance.

The primary objective of financial reporting is to provide high-quality financial reporting information concerning economic entities, primarily financial in nature, useful for economic decision making. Providing high-quality financial reporting information is important because it will positively influence capital providers and other stakeholders in making investment, credit, and similar resource allocation decisions enhancing overall financial performance.

The Global Reporting Initiative guidelines (GRI) identify principles for defining report quality. This group of principles guides choices on ensuring the quality of information in the sustainability report, including its proper presentation. The GRI Sustainability Reports are prepared on the basis of certain principles which define the contents and quality of the report. These include Materiality, Stakeholder Inclusiveness, Sustainability Context, Completeness, Balance, Comparability, Accuracy, Timeliness, Clarity and Reliability.

Today, the finance sector is considered as one of the key contributing sectors behind economic solidity and growth, and it is highly observable to public evaluation. The general public now has high expectations of the government and private sector for responsible behaviour. Today's finance sector's business environment is too competitive and dynamic where challenges are updated day by day. In order to face the new challenges, firms should build good bond economically, environmentally and socially. Therefore, most of the companies engage with the CSR activities and tend to build their corporate image through sustainability reporting.

There are 62 companies listed under the banking, finance and insurance sector in the Colombo stock exchange. But, not all the companies produce sustainability

reports. The low percentage of sustainability reporting is due to many factors such as high reporting cost, difficulty in measuring performance, difficulty in convincing the companies to be proactive in sustainability reporting, lack of awareness and companies' assumptions of additional cost and resources required for reporting, the poor performance of companies and inconsistency in reporting.

Sustainability reports vary considerably in their quality largely due to their voluntary nature and the lack of an accountability framework in sustainability reporting. Thus, companies are free to choose from the guidelines in any way they prefer, and this contributes to the difficulty of assessing the quality. Those shortages of sustainability reporting highlight the importance of developing a quality measure of sustainability reporting. The topic of sustainability reporting in Sri Lanka receives relatively less attention in research compared to other parts of the world since sustainability reporting is not mandatory in Sri Lanka, as with many other countries in the world. Therefore, this study attempts to cover this lacuna in the sustainability reporting research agenda in the region, by filling the knowledge gap by measuring the quality of sustainability reporting and the measurement of the impact of quality variation on the financial performance in a Sri Lankan context.

Problem Statement

From the background described above, the problem of the study was identified as "what is the extent of the impact of quality of sustainability reporting of companies on their financial performance in the Banking, Finance and Insurance sectors in Sri Lanka?

Research Questions

Based on the research problem identified above, the following research questions were raised for the study.

1. What is the extent of the quality of sustainability reporting of companies in the Banking, Finance and Insurance sectors in Sri Lanka?
2. What is the relationship between the quality of sustainability reporting and the financial performance of the companies in the Banking, Finance and Insurance sectors in Sri Lanka?
3. Is there any significant influence of quality of sustainability reporting on financial performance in the companies in Banking, Finance and Insurance sectors in Sri Lanka?

Objectives of the Study

1. To identify the level of quality of sustainability reporting of companies in the Banking, Finance and Insurance sectors in Sri Lanka.
2. To explore the relationship between the quality of sustainability reporting and the financial performance of the companies in the Banking, Finance and Insurance sectors in Sri Lanka
3. To evaluate any significant influence of quality of sustainability reporting on Financial Performance in the companies in Banking, Finance and Insurance sectors in Sri Lanka.

Literature Review

The company's financial performance can be viewed from the financial statements reported by the company. Consequently, a good performing company will reinforce management for quality disclosure (Herly&Sisnuhadi, 2011). Return on assets is a better metric of financial performance than income statement profitability measures like return on sales (J Hagel et al, 2010). Sustainability report can be defined as "a firm-issued general purpose non-financial report that provides information to investors, stakeholders, and the general public about the firm's practices involving environmental, social, and governance (ESG) issues, either as a stand-alone report or as part of an integrated report" (Ioannou and Serafeimin, 2012). An integrated report is a single document that presents and explains a company's financial and non-financial environmental, social, and governance performance (Eccles and Krzus, 2010). Global Reporting Initiative (GRI 2006) defines sustainability reporting is the practice of measuring, disclosing and being accountable to internal and external stakeholders for organizational performance towards the goal of sustainable development.

Sustainability reporting is promoted by governments and stock exchanges by adopting laws and regulations that specifically mandate this form of disclosure. Ioannou and Serafeim (2012) found that companies that initiate sustainability disclosures after the adoption of Mandatory Corporate Social Responsibility (MCSR) laws, reduce energy as well as waste and water consumption significantly, while they increase investments in employee training.

Disclosure of sustainability information forces companies to manage these matters more effectively to avoid having to disclose bad sustainability performance to their multiple stakeholders. According to Rob Gray (2006), the performance of companies implementing sustainability principles is superior because sustainability is a catalyst for enlightened and disciplined management and the concept of corporate sustainability has long been very attractive to investors

because of its aim to increase long-term shareholder value. Sustainability reporting quantity and quality have attracted major interest in accounting literature since the publication of a remarkable paper by Hasseldine, Salama and Toms (2005). Using a subjective measure of environmental disclosure quality, Hasseldine et al (2005:231) offer the first empirical evidence that the "quality of environmental disclosure rather than mere quantity has a stronger effect on the creation of environmental reputation amongst executive and investor stakeholder groups.

A study done by Wijesinghe and Senarathne (2011) reveals a positive and significant relationship between Corporate Social Responsibilities and Return on Assets. According to SAM and Robeco (2011), results reveal the positive and significant relationship between sustainability reporting and financial performance. The principles for defining report quality are particularly important for stakeholders, including investors, since they allow the latter to "make sound and reasonable assessments of performance, and take appropriate action" (GRI, 2014, p. 13). These principles cover six main aspects – balance, comparability, accuracy, timeliness, clarity, and reliability – the analysis of which is essential for understanding the objectives of sustainability reporting, as well as of certain impression management practices that tend to question the transparency of information.

Conceptualization of Variables

This study was a cross-sectional explanatory study. The main concepts of the study are the quality of sustainability report and the financial performance. The first concept is indicated with balance, clarity, accuracy, timeliness, comparability, and reliability. The latter is indicated by Return on Asset. The quality indicators were measured by perceived responses of various users of sustainability reports and the Return on Assets was measured by the calculation of ratio using annual reports of companies.

Qualities of sustainability reporting were identified from the literature review on the principles of Global Reporting Initiative as given below: **Balance** means that the report should contain information reflecting positive and negative aspects of the enterprise's activities to enable an assessment of overall performance. The report should avoid selections and omissions, but should possibly provide a well-balanced assessment of the enterprise's effects. **Comparability** is defined as the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. Information related to economic, social and environmental effects should enable comparing these data against assumed objectives, enterprise's past performance and the performance of the other organizations. **Accuracy** is the condition or quality of being true, correct, or exact;

freedom from error or defect; precision or exactness. Presented information should be sufficiently accurate to reflect the actual state while being understandable for the most numerous group of stakeholders. **Timeliness** means that having information available to decision-makers before it loses its capacity to influence decisions. It refers to the time it takes to reveal the information and is related to decision usefulness in general. **Clarity** as the quality of being clear and easy to understand. The information contained in the report should be comprehensible and have a readable form. **Reliability** relates to the quality of measurement in terms of the consistency or repeatability of the measures. Information should be gathered, analysed and disclosed in a way that enables internal and external auditors to verify their veracity.

Operationalization of variables

The qualities of sustainability reporting were operationalized by identifying indicators which were measured using the five-point rating scaled questionnaire. The indicators for the dimensions of the quality were: **Balance:** positive and negative aspects and materiality; **Comparability:** comparativeness between time period and comparativeness between firms; **Accuracy:** Sufficiency and detailed information; **Timeliness:** periodicity and frequency; **Clarity:** usefulness, understandability, and accessibility; and Reliability: assurance and supportive documentation. The financial performance was operationalized with a single indicator, Return on Assets, which was measured by the calculation of ratio, net income being the numerator and total assets being the denominator.

Hypotheses

To answer the research questions of this study, the following hypotheses were formulated based on the literature review:

H1: There is a significant positive relationship between Quality of Sustainability Reporting and Financial Performance of Companies.

H2: Quality of Sustainability Reporting has a significant positive impact on Financial Performance of Companies.

Methodology

The study was carried out using 5-year data obtained from the sample of 20 listed companies operating in the banking, finance, and insurance industries in Sri Lanka. The data on net income and total assets were extracted from the 100 relevant annual reports to use them in calculating Return on Assets in order to measure the financial performance. A self-administrated questionnaire was designed and distributed among 100 users of sustainability reports of sample companies, consisting of

managers, investors, stockbrokers, tax officers and auditors, along with the copies of the reports under review to measure the quality of the reporting.

A sample of the study included twenty out of forty-three companies, which practice sustainability reporting, operating in the banking, finance, and insurance, industries in Sri Lanka listed in Colombo stock exchange for a period of five years from 2012 to 2016. 100 users of the sustainability reports of those 20 companies were identified for involving them in evaluating the degree of quality of reports using the questionnaire given to them.

Method of Data Analysis and Hypothesis Testing

The descriptive, correlation and regression analyses were applied as the techniques to analyze and evaluate the data collected using the software SPSS version 22.0. The descriptive analysis was made to find out the frequency distribution, mean, and standard deviation for every variable. Correlation and regression analyses were done between the average quality level of sustainability reporting in a year and return on assets in the corresponding year. A hypothesis testing was done by forming the Null Hypothesis (H_0) and Alternate Hypothesis (H_A). Hypotheses were tested using the results of correlation (Pearson's Product Movement Correlation) and regression (linear) analyses choosing a probability level of significance (p-value) at 5% for measuring the error judgment.

Results and Discussion

A descriptive analysis was done on the data collected on the quality level of sustainability reporting and return on assets. The results of the analysis as presented in Table 1.1 indicated that the data recorded on all the variables are approximately normally distributed. The mean values of 2.57 and 2.95% were found for the quality level of sustainability reporting and return on assets respectively. The quality of sustainability reporting and its dimensions are found at a moderate level among the companies in the financial industries, and the variations in the quality dimensions and indicators are insignificant as indicated by the standard deviations and other statistics.

Pearson's Correlation analysis as extracted in Table1.2 indicated that the quality of sustainability reporting is positively and significantly correlated with the returns on assets of the companies with a coefficient of 0.575.

Linear regression analysis as summarized in Table 1.3 revealed that the quality of sustainability reporting has significantly explained the variation in return on assets, the indicator of financial performance, with the R^2 value of 0.33.

Table 1.1: Descriptive Statistics

Variables	N	Mean	Std. Deviation	Range	Minimum	Maximum	Skewness	Kurtosis
Balance	100	2.616	0.918	3.67	1.00	4.67	0.23	-1.09
Comparability	100	2.538	0.784	3.20	1.20	4.40	-0.03	-1.12
Accuracy	100	2.568	0.867	3.25	1.00	4.25	-0.13	-1.17
Timeliness	100	2.585	0.805	3.50	1.00	4.50	0.17	-0.85
Clarity	100	2.530	0.815	3.50	1.00	4.50	0.27	-0.71
Reliability	100	2.563	0.821	3.50	1.00	4.50	0.24	-1.03
Overall Quality of Sustainability Reporting	100	2.567	0.776	3.08	1.20	4.28	0.08	-1.17
Financial Performance (ROA)	100	2.948	0.779	3.78	1.11	4.89	-0.07	-0.46

Source: Output of SPSS Analysis

Table 1.2: Correlation between the Quality of Sustainability Reporting (IV) and Financial Performance (DV)

Variables		Quality of Sustainability Reporting	Financial Performance
Quality of Sustainability Reporting	Pearson Correlation	1	0.575**
	Sig. (2-tailed)		0.000
	N	100	100
Financial Performance	Pearson Correlation	0.575**	1
	Sig. (2-tailed)	0.000	
	N	100	100

**. Correlation is significant at the 0.01 level (2-tailed).

Source: Output of SPSS Analysis

Table 1.3: Regression between the quality of sustainability reporting (IV) and Financial Performance (DV)

Method	R	R^2	Adjusted R^2	F	Sig. F	b - Constant	B - QSR	Beta	t	Sig.t
Linear	0.575	0.330	0.324	48.375	0.000	1.465	0.577	0.575	6.955	0.000

Source: Output of SPSS Analysis

According to results the Regression Equation for the financial performance is: FP = 1.465 + 0.577 (QSR). The b value of the equation, the gradient of the regression, is 0.577, which is significant at 95% (Sig.t = 0.000). As indicated by R^2, 33% of the variance of financial performance is explained by the quality of sustainability reporting with the standardized beta of 0.575. The F value is 48.375, that is significant at 95% (Sig.F= 0.000), which suggests that quality of sustainability reporting has significantly explained 33% of the variance of financial performance of the companies in the sample.

Hypothesis Testing

The hypothesis $H_1$was: There is a significant positive relationship between the quality of sustainability reporting and the financial performance ($r < 0$). The Null hypothesis was formulated as H_0: There is no significant positive relationship between quality of sustainability reporting and the financial performance ($r > 0$). According to the results of the Pearson correlation analysis, the coefficient of correlation is 0.575, which was significant at 95% confidence level ($P > 0.05$). Therefore, according to the correlation coefficient the Null hypothesis is rejected and the alternative hypothesis is accepted since the positive correlation coefficient is significant. Hence, the data supported the hypothesis that the quality of sustainability reporting is positively and significantly correlated with the financial performance of the companies under the study.

The hypothesis $H_2$was: The quality of sustainability reporting has a significant positive impact on the financial performance ($b > 0$). The Null hypothesis was formulated as H_0: The quality of sustainability reporting has no significant positive impact on the financial performance ($b=< 0$). According to the results of linear regression analysis, the coefficient of regression (b) is found at 0.577 which was significant at 95% confidence level ($P > 0.05$). Therefore, according to the regression coefficient the Null hypothesis is rejected and the alternative hypothesis is accepted since the b value is found significant. Hence, the data supported the hypothesis that the quality of sustainability reporting has a significant positive impact on the financial performance of the companies under the study.

It is concluded that the quality of sustainability reporting has been moderately and positively, significantly, correlated with the financial performance of the companies operating in the banking, financing, and insurance industries in Sri Lanka. Further, the quality of sustainability reporting has a significant impact on the financial performance of the companies in the industries. Hence, the quality of sustainability reporting has a significant influence on determining the financial performance of companies in the banking, financing, and insurance industries in Sri Lanka. It is therefore recommended that companies can improve their financial performance if they enhance the quality of sustainability reporting.

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