Malaysian code on corporate governance and risk management committees towards firm's performance in Malaysia

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Abstract

Risk management has become a predominant concept in corporate governance and is associated with the idea of internal control that can be evaluated by using risk-based approach. Past studies (Kallamu, 2015; Ng, Chong & Ismail, 2013), have argued that there is a need for a separate Risk Management Committee (RMC) due to negligence of audit committee in monitoring firm performance (Bates & Leclrec, 2009). Apart from that, the researchers claimed that a firm that establishes an RMC can focus on risk issues (RMC), thus, effectively monitors risk and manages internal control system. The current study used Tobin's Q and ROA to evaluate the firm performance of listed companies from Consumer Goods Sector on Bursa Malaysia. The data was analysed using Panel data Techniques and the findings suggest that a separate risk management committee (RMC) which consists of most independent non-executive directors would increase firm market valuation and adversely affects accounting returns. The latter results support Stewardship Theory which suggests that executive directors are good stewards in providing better monitoring of the business due to their exquisite knowledge.

1.0 Introduction

The concept of risk management has been given emphasis since the establishment of Malaysian Code on Corporate Governance in 2000. The guideline was viewed as one of the principal responsibilities of the board of directors (Ghazali & Manab, 2013) to protect the interest of the shareholders by preserving the effective internal control to include risk management (paragraph 4.14, MCCG 2000) and to identify the risk and execute appropriate mechanism to manage the risk (paragraph 4.17). In view of the complexity of capital market and the need to enhance corporate governance practice, the MCCG 2000 was revised in October 2007. The revision emphasised two (2) major aspects of the corporate governance elements, namely board of directors and audit committee function. According to Ghazali and Manab (2013), the Malaysian Code on Corporate Governance 2007 marked a significant move in corporate governance practices as it is now mandatory instead of voluntary for companies to have its internal auditing committee that includes a risk management team. The revised Code in 2007 outlined three (3) major areas that need to be considered by the chief of internal audit. They include reviewing and evaluating the effectiveness of risk management, internal control and governance process in the organization. In relation to the broad principles and specific recommendations on structures and processes, the MCCG 2012 set out eight (8) broad principles and twenty-six (26) specific recommendations that make good corporate governance an integral part of their business dealings and culture. Among these principles, the risk management guidelines fall under the Sixth Principle which emphasises the requirement for the board to establish a sound risk management framework and internal controls system. Although the observance of the MCCG 2012 by companies is voluntary, listed companies are required to report on their compliance with the MCCG 2012 in their annual reports. In 2017, a new Malaysian Code on Corporate Governance was introduced by the Securities Commission to ensure that the governance practice in Malaysia is

regularly improved. The revised code of MCCG 2017 has heightened the importance of having strong internal control and risk management functions to effectively monitor the company's risk management framework, policies and its implementation. In relation to this, the new MCCG requires all business are required to establish Risk Management Committee (RMC) that comprises most independent directors.

In view of the significance for companies to identify and execute appropriate mechanism to manage risk, Akindele (2012) argues that firm performance largely depends on the risk management mechanism. In this perspective, it is believed that firms that are proactive in risk management activities can detect and prevent frauds in financial reporting, thus, reducing the likelihood of unexpected losses, reputational damage or strategic setbacks. Likewise, a board that puts in place firm-wide risk management system increases risk awareness within a firm. This is justifiable as poor monitoring of risks may result in significant losses for companies that may affect their overall performance. As a matter of fact, auditors are likely to perceive boards of directors that actively participate in risk management as more thorough when reviewing the effectiveness of internal controls as it improves the company's overall performance (Walker, 2009). Notably, numerous studies have indicated a positive relationship between RMC and company's performance (Zemzem & Kacem, 2014; Hoyt & Liebenberg, 2011; Gordon, Loeb, & Tseng, 2009) due to its role as a supervisory mechanism of risk (Subramaniam, McManus & Zhang 2009, 2009). Empirical studies also show that the establishment of RMC in companies is affected by corporate governance and risks related to financial reporting (Kallamu, 2015; Viljoen & Coetsee, 2014; Subramaniam, 2009).

About shareholders' wealth maximization goals, Law and Yuen (2018) stated that an audit committee plays a crucial role in the corporate governance process that is the cornerstone of shareholder protection. As a matter of fact, the establishment of audit committee which comprised of independent non-executive directors aims to mitigate corporate fraudulent or creative accounting practices through internal control. This in turn helps to improve corporate governance practice of firms. However, there are doubts about audit committees' effectiveness in monitoring the risk management issues despite of their substance value towards company's performance (Badriyah, Sari & Basri, 2015). The malpractices among conglomerates in Malaysia such as Megan Media and Transmiles have heightened the awareness of risk management due to many recent corporate disasters and unexpected business failures (Walker, Shenkir & Barton, 2002). This creates a need for a separate risk management committee (RMC) due to audit committee's inability to perform functions of both audit committee and RMC (Bates & Leclerc, 2009). A separate committee that specifically focuses on risk issues (RMC) is an effective mechanism in support of the board of directors to fulfil their responsibilities in the task of monitoring risk and internal control management. Such a committee can potentially become a critical resource for boards in meeting their risk management responsibilities. Yet, empirical evidence on the formation and nature of RMCs remain scant and limited (Ishak & Yusof, 2013). In other words, there is little empirical evidence on both corporate governance and firm-related factors associated with an organisation's decision to establish a separate RMC as opposed to a combined RMC committee.

In view of these limitations, the current study aims to examine the effectiveness of a separate risk management committee (RMC) towards Malaysian Public Listed Company's performance measured by Tobin's Q and Return on Assets. About the establishment of RMC in a company, it is expected that other firm characteristics such as firm size and leverage risk would also have effect on risks faced by company (Badriyah, Sari, & Basri, 2015).

2.0 Literature Review

Previous research on corporate governance often uses the agency theory as a theoretical basis, in relation to the establishment of a risk management committee (RMC) in an organization. The theory aims at resolving two problems that can occur in agency relationships. These problems arise due to conflict of interests between the principal and the agent, which arise due to the separation of ownership and control (Davis, Schoorman, & Donaldson, 1997). According to the researchers, managers tend to develop opportunistic behaviour due to legitimacy authority that has been bestowed to them by the shareholders. This behaviour leads to a conflict of interest causing agency problem. For this reason, the committee formed by the board of commissioners is an application of effective corporate governance mechanisms to address the agency problem (Cai, Qian & Liu, 2008). Usually, RMC is predicted to exist in a situation

where the agency cost tends to be high, for example, in the situation of high leverage and large sized companies (Subramaniam et al., 2009; Chen, Kilgore & Radich, 2009).

Another theory relevant to the current study is the Stewardship Theory. Unlike agency theory, this theory suggests that stewards are satisfied and motivated when organizational success is attained. It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. Fama (1980) contend that executives and directors are also managing their careers in order to be effective stewards of their organization. The managers are required to be stewards in the organization by protecting the shareholders' interests as a way of instilling strong corporate governance to minimize the risk of loss by shareholders. Indeed, this can minimize the costs aimed at monitoring and controlling behaviours in agency problems (Davis, et al., 1997).

In relation to the development of RMC as a sub-committee of the BOD, researchers found that larger companies tend to establish an RMC as they possess greater amount of assets. This imposes greater risks to the company as it requires external funds to support funding in capital market (Mirawati, 2014). Notably, companies that have a large portion of long-term liabilities tend to have greater financial risk as higher leveraged firms are more likely to have debts covenants and higher concern about risks (Goodwin & Kent, 2006). Therefore, there will be a greater demand for such companies to form RMC to oversight such risks as lenders tend to demand better internal controls and related monitoring mechanisms. With regard to the firm's performance measurement, return on assets (ROA) has been used extensively to represent actual firm performance (Ponnu, 2008) which measures the amount of earning generated from an invested capital asset (Epps & Cereola, 2008). Apart from ROA, another frequent proxy used to measure firm market performance in relation to corporate governance is Tobin's Q. Tobin's Q is also known as q ratio and Kaldor's v which measures the market performance of firms which is calculated as the market value of a company divided by the firm's assets (Kamardin & Haron, 2011; Haniffa & Hudaib, 2006).

3.0 Methodology

This research focuses on Malaysian public-listed companies from Consumer Goods Sector for a period of 9 years, starting from the year 2010 until 2018. The period of the study is justified by the requirement on best practices of the Code of Corporate Governance to include a risk management team in an internal auditing committee as a mandatory requirement in MCCG 2007 (Ghazali & Manab, 2013). However, due to unavailability of data, the current study was not able to include the data for the year 2008 where the requirement on MCCG 2007 took effect. Thus, this influence the sample size because it relied heavily on the corporate governance disclosure by the listed companies.

In relation to the measurement of RMC, the current study used a dichotomous variable of "1" to represent the compliance of the listed company to set up a separate RMC and "0"as a non-compliance on the listing requirement of Bursa Malaysia. Therefore, based on a filtration process, there are only 19 listed companies undertaken for data analysis since not all listed companies of Consumer Goods Sector have established a separate risk management committee (RMC). This could be due to the requirement by MCCG 2017 that is still recent. Additionally, the Listing Requirement by Bursa Malaysia under Paragraph 15.25 also required for any listed company to constitute a RMC which comprises a majority of independent directors to oversee the company's risk management framework and policies (of Bursa Malaysia Listing Requirements). As a matter of fact, some listed companies under the sector justified that the Board is of the view that a separate Risk Management Committee is not required. Therefore, instead of establishing a separate RMC, its audit committee is renamed as Audit and Risk Management Committee (ARMC) and is given additional responsibility to review and manage key business risks of the company.

About the choice of sector in Bursa Malaysia, the Consumer Goods Sector or Fast-Moving-Consumer-Goods (FMCG) industry has been chosen due to its long history of generating reliable growth through mass brands. However, due to recent technology-driven trends, foreign-exchange effects and inflation faced by the country, this sector experienced a shift in consumer behaviours. This shift and the establishment of RMC in this sector presents an intriguing concern in this study of corporate governance and its risk management initiatives.

Meanwhile, the empirical models used in this study are based on firm to firm framework (Panel data technique) as shown below:

Model 1

$$\ln \text{TOBINS Q}_{it} = \alpha + \beta_1 \text{SEPRMC}_{1it} + \beta_2 \ln \text{FSIZE}_{2it} + \beta_3 \text{LEV}_{3it} + \epsilon_{it} \quad \dots (1)$$

Model 2

$$\text{ROA}_{it} = \alpha + \beta_1 \text{SEPRMC}_{1it} + \beta_2 \ln \text{FSIZE}_{2it} + \beta_3 \text{LEV}_{3it} + \epsilon_{it} \quad \dots (2)$$

In these models, Tobin's Q or the Kaldor's v and Return on Assets (ROA) are the dependent variables that are used to measure firm performance, while SEPRMC, FSIZE and LEV are the independent variables that are used to predict the firm's performance. As for the coefficients or multipliers of $\beta1$, $\beta2$ and $\beta3$, they describe the size of the effect the independent variables on the dependent variables. The constant variable of alpha, α, is the predicted value that Tobin's Q and ROA would have when all the independent variables are equal to zero. Table I describes the proxies for each variable:

Table I: The Measurement of Independent and Dependent Variables

Variables	Description	Proxies	Authors
Firm Performance	Return on Assets (ROA)	Net income in each period to the total value of its assets	Kamardin and Haron (2011); Haniffa and Hudaib (2006); Lam and Lee (2008)
Firm Performance	lnTOBINS Q	Natural logarithm of Total market value of firm/Total assets	Kamardin and Haron (2011); Haniffa and Hudaib (2006); Drobetz et al. (2004); Himmelberg et al. (1999); Holderness et al. (1999)
Corporate governance	Separate Risk management committees' size (SEPRMC)	Dichotomous Variable, 1 if a firm sets up a separate RMC, 0, no separate RMC	Ali and Mastuki (2017); Yatim (2010)
Firm characteristics	lnFirm Size (FSIZE)	Natural logarithm of company's total assets	Subramaniam et al. (2009)
Firm characteristics	Leverage (LEV)	The proportion of total long-term liabilities to total assets	Subramaniam et al. (2009)

In this study, the panel data analysis involved repeated observations on the Tobin's Q and Return on Assets (ROA) for the sample size in relation to the independent variables for a period of 9 years. This allowed the researcher to observe the performance of individual company in relation to the existence of a separate RMC. There are several alternatives used to estimate the panel data equations in the estimation procedure. However, for this study, the researcher only utilized the Fixed Effects Model and Random Effects Model. In order to assess the significant effects of the existence of a separate RMC towards company's performance, the researcher had to compare results from the hypotheses tested under Return on Assets and the Tobin's Q. The hypothesis testing of this study is based on non-directional hypothesis whereby the null hypothesis indicates no significant relationship between the existence of a separate RMC and firm performances. Meanwhile, the alternate hypothesis indicates a significant relationship between the existence of a separate RMC and firm performances.

4.0 Data Analysis and Findings

As presented in Table II, the findings indicate that both empirical models are poolable to Panel data technique. The Hausman specification tests results provide two different models used for the dependent variables. The Tobin's Q is based on Fixed Effect with Heteroscedasticity and Autocorrelation Consistent (HAC), while the dependent variable of ROA is using the Random Effect Model of FE Robust. Findings from the regression analysis on firm performance indicate that there is a positive relationship between a corporate governance requirement on RMC and firm market performance measured by Tobin's Q. The result also presents a significant p-value of less than 0.05 which indicates that a firm with a separate RMC enhances a market valuation of the company (Kallamu, 2015). The result also implies that the market believes a firm with RMC has a good monitoring mechanism, indirectly increasing the market

performance of the firm. Meanwhile, a weak negative correlation between the existence of a separate RMC and firm performance indicate that the listing requirement by Bursa Malaysia on the Practice 9.3 where the board establishes a Risk Management Committee that comprises a majority of independent directors does not contribute to the increase in performance measured by ROA. This is contrary to the theoretical expectation based on agency theory and contrary to evidence reported by Tao and Hutchinson (2012), Yeh, Chung, and Liu, (2011) and Minton, Taillard and Williamson (2010). The negative association could be due to inadequate monitoring by independent non-executive directors or inadequate technical knowledge and experience needed to perform the monitoring role effectively (Kallamu, 2015; Klein, 1998; Tao & Hutchinson, 2012). On the other hand, the result supports stewardship theory which suggests that executive directors are good stewards due to their superior knowledge of the business which enables them to provide better monitoring of the company's business.

Another incongruent finding between the two firm performances measurement is on the leverage, whereby, it indicates a significant correlation and the highest correlation compared to other relationship among the variables. A positive relationship between a leverage and firm financial performance measured by Tobin's Q indicates that higher levels of leverage in the capital structure of listed companies under Consumer Goods Sector in Malaysia are associated with a stronger firm market performance. It also suggests that leverage boosts the market performance of firms of all sizes. This finding is consistent with that of Ibhagui and Olokoyo (2018) which found a significant relationship between financial leverage and firm market performance. However, the result differs when firm performance is measured based on ROA. The findings indicate an inverse relationship between financial leverage and firm performance which supports the assumptions of the pecking order theory. As presented in Table II, increase in the leverage will lower firm performance by 0.2378. As the p values are less than 0.05, the hypotheses are accepted at the 95% confidence level, thereby indicating that financial leverage has a statistically significant negative effect on ROA. The findings are consistent with that of Quang and Xin (2014), who found that the capital structure of the listed firms (non-financial firms) in Vietnam has a statistically significant negative effect on financial performance measured by ROA and ROE. Additionally, the study of Saeedi and Mahmoodi (2011) concerning the relationship between financial leverage and firm performance of listed companies on the Tehran Stock Exchange (TSE), also suggested a negative relationship between capital structure and ROA. The regression results revealed that firm size has an insignificant negative relationship with ROA. This finding is consistent with Kallamu (2015) and several other studies.

Table II: Multivariate Regression Analysis Based on ROA and Tobin's Q

| | Pooled OLS | | Fixed Effect | | Random |
| | lnTobin's Q | ROA | with robust | Effect | |
	(HAC)	(FE Robust)	(ROA)		(lnTobin's Q)
SEPRMC	-1.008***	-0.0049	-0.0419049		0.5178**
	(-2.29)	(-0.14)	(-0.99)		(2.14)
lnFSIZE	0.2416***	-0.0030	-0.003159		-0.586***
	(2.37)	(-0.37)	(-0.05)		(-6.31)
LEV	-8.447***	-0.3877	-0.2378***		.7158*
	(-4.08)	(-2.34) ***	(-2.24)		(1.93)
Constant	-3.013***	0.2494***	0.239		7.00***
	(-2.42)	(2.53)	(0.27)		(5.61)
BP-LM Test	499.35	420.22	-		
	(0.001) ***	(0.001) ***	-		
Hausman Test	-		0.31		9.35
			(0.9587)		(0.025) ***
Multicollinearity (VIF Test)	-		1.57		1.56
Heterocedasticity (Modified-Wald Test)	-		16304.99		2.7e+05
			(0.001) ***		(0.001) ***
Serial Correlation (Woolridge Test)	-		0.355		465.98
			(0.5587)		(0.001) ***
R-squared (R²)	0.1141	0.0667	0.3999		0.0614

Wald Chi²	-	-	77.79
Prob > Chi²	-	-	(0.001) ***
F (3, 18)		5.20	-
Prob >F		(0.0092) ***	-
Observations	169		

*Note: *** Significant at 1% level; ** Significant at 5% level and * Significant at 10% level. BP-LM represents Breusch and Pagan Langrangian Multiplier Test whereas VIF represents Variance Inflation Factor. Symbol "- "indicates non-related test for the model.*

5.0 Conclusion

This study was conducted to investigate the effects of having a separate Risk Management Committee's in relation to firm performance. The dependent variables in the study include Tobin's Q and ROA as indicators while the independent variables comprised of RMC, firm size and leverage. The main objective of the study is to examine the effects of the existence of RMC in an organization, its functions as a key governance support mechanism towards firm performances in monitoring the organisation's risk management strategies, policies and processes. The results of the regression analysis indicate that there is a significant positive relationship between a separate RMC and firm performance measured by Tobin's Q. Meanwhile, results also indicate a weak negative correlation and insignificant between separate RMC and firm performance measured by ROA. Overall, both results on firm performances indicate that leverage significantly influences a firm's Tobin's Q and ROA.

6.0 References

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