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The Influence of Malaysian Code of Corporate Governance (MCCG) to Enterprise Risk Management (ERM) and Value Creation

Zahiruddin Ghazali* and Norlida Abdul Manab**

This study aims to highlight whether the implementation of Malaysian Code of Corporate Governance in 2000 and the revise version in 2007 gives an impact to companies listed in the Malaysian Bourse. Using a standard and reliable variables with acceptable testing methods provide justifiable methodology of testing several aspect of companies specific characteristics. From test result, it is found that MCCG2000 produces more impact compares to MCCG2007 and non-financial companies benefited more compares to finance related companies.

JEL Code: G28, G32, M41,

1. Introduction

It is a common and acceptable knowledge that the East Asian financial crisis in 1997 has left a scar on Malaysian firms and the economy as a whole. Jin (2001) in his study estimated that one tenth of the 800 public-listed companies on the Bursa Malaysia were severely affected by it and poor corporate governance and risk management was cited as a major contributor to the companies' failure. This in turn caused severity in corporate governance problems in the Bursa listed companies. An earlier study by Claessens, Djankov, and Lang (1998) also views that much of the East Asian financial crisis has in part been attributed to the weak performance and risky financial structures of corporates itself. Their study reveals that operational performance of East Asian corporates was indeed not as phenomenal as many had thought with investment with risky projects/ventures. Moreover, their study suggest that the financial structures of many East Asian corporates could not withstand the combined shocks of increased interest rates, depreciated currencies, and large drops in domestic demand as where the trigging factor of the 1997 Crisis. Finding from their study is further supported by Poon (1999) specifically to Malaysian financial and economic condition.

Malaysian government in March 2000, through its financial regulator formularizes and introduces The Capital Market Master-plan to stamp out governance woes which were viewed to be the culprit to the 1997 crisis. Apart from the Master-plan, the Malaysian Code on Corporate Governance 2000 (MCCG 2000) was also introduced where risk management for the first time clearly stated and viewed as one of the principal responsibilities of the board of directors.

**Dr. Zahiruddin Ghazali, Department of Finance, School of Economics, Finance and Banking, Universiti Utara Malaysia, Malaysia. E-mail; uddin@uum.edu.my*

**Norlida Abdul Manab, Department of Banking and Risk Management, *School of Economics, Finance and Banking, Universiti Utara Malaysia, Malaysia.E-mail; norlida@uum.edu.my*

In MCCG 2000, it is stated in the 3rd and the 6th of principle responsibilities of the BOD on the Best Practice Provision AA1 in Part 2, which requires the board to understand the principal risks of all aspects of the business in order to achieve a proper balance between risks incurred and potential return to shareholders, and to ensure that there is a sufficient framework of reporting on internal financial controls and regulatory compliance. Nonetheless, the requirement on best practices of the Code is voluntary.

In October 2007, MCCG 2000 was revised from lessons learned since induction. In essence the Malaysian Code on Corporate Governance revised 2007 (MCCG 2007), recognizes the importance of the internal audit function by requiring all companies to have an internal audit function. In order to preserve the independence of the internal audit function, the head of internal audit should report directly to the audit committee. Moreover, MCCG 2007 strives to strengthen the role of audit committees by requiring the committees to comprise fully of non-executive directors. In addition, all its members should be able to read, analyse and interpret financial statements so that they will be able to effectively discharge their functions. Although at a glance, MCCG 2007 seems to be a minor improvement from MCCG 2000. Nonetheless, it is a significant move as it is now mandatory instead of voluntary for a company to have its own internal auditing committee which includes its risk management team.

Risk management has begun as a field in the early 1950s was limited in scope to pure loss exposures only where risks were managed through controlling and financing techniques. Insurance has been the most popular financing approach in managing corporate risk. It has been used to manage property, liability, and related insurable risks. This approach is known as Traditional Risk Management (TRM) where risks are managed by independent departments or units where each group has its own languages, skills and procedures.

The global and specific company environmental change of risk as well as the complexity and speed of these changes have increased the uncertainty and risks endure by the company. These rapid changes have shown that managing risk by isolation is no longer suitable due to traditional risk managers have failed to develop skills that would enable them to contribute to the broader idea of integrated risk management approach within their business entities (Conley, 1999) and to consider shareholders wealth in the decision making process (Meier, 2000). Thus, most of the companies now have moved from the traditional way of risk management to an integrated or enterprise risk management.

Enterprise Risk Management (ERM), is relatively a new trend of risk management and has become a global issue and receiving much attention in this part of the world including Malaysia for all types of organizations regardless of sizes. Paradigm shift of the ERM approach arises from four important issues, namely, the increasing of challenges in internal and external factors of risk and the disintegrating approach of TRM. Follow by the occurring of recent corporate scandals and financial collapses, then, the increasing concern on corporate governance issues; and finally, the driving motivation to create and preserve shareholder value.

The fourth issue mentioned in the previous paragraph represents the main idea of this paper. Nonetheless, due to the nature of limited space in any seminar/conference paper, this paper would only enable to provide only a glimpse of accomplishment of both MCCG to ERM practices by Malaysian companies.

2.0 Methodology

The primary objective of our study is to examine the changes in financial characteristics of firms' adopting ERM. Unfortunately, firms do not, in general, publicly announce the adoption of ERM, and in addition tend to disclose only minimal details of their risk management programs. This view concurs to earlier study by Tufano (1996) and Pagach and Warr (2010). Therefore, this study focuses on implementation of MCCGs by the Securities Commissions (SC) and the Malaysian Bourse (Bourse) as a signal of a firm's adoption of an enterprise risk management process. There are good reasons to believe MCCGs should coincides with the decision to follow an ERM program as MCCGs are strictly governs and enforced by the Bank Negara, SC, and the Bourse.

This study employs the use of random alphabetical listing selection of listed companies in the 2010 Bursa Listed Companies Schedule excluding financial and insurance regulated companies. In this study all financial and insurance regulated companies (37 companies) are included as another sample to be treated as placebo samples. The primary reason to this is that these companies are "said to be" compliance to not only compliance to local ERM but also with BASEL II accordance. The following table summarizes this study samples;

Table 1
Financial and Non-financial Samples by Sector

	Frequency	Percent	Cumulative Percent
Construction	19	4.7	4.7
Consumer	44	10.9	15.6
Finance *(placebo)*	37	9.1	24.7
Hotels	3	.7	25.4
Industrial Product	100	24.7	50.1
IPC	3	.7	50.9
Non-Regulated Finance	50	12.3	63.2
Plantation	21	5.2	68.4
Properties	47	11.6	80.0
Technology	9	2.2	82.2
Trading & Services	72	17.8	100.0
TOTAL	405	100.0	

To test whether MCCG 2000 and MCCG 2007 implementation are associated with changes in key financial variables, the basic approach is to measure changes using Independence t-Test and Paired-Sample t-Test in these variables in the years after the code implementation relative to the years before. The following and its motivation are the variables used in the analysis.

Financial Characteristics

This study examines the financial characteristics that related to the possibilities of the company experiencing a costly outcome. The first financial characteristic is leverage as companies with higher leverage are prone to experience financial distress. Moreover, excessive leverage may also limit a company's ability to pursue additional profitable investment projects. Pagach and Warr (2010) points out that the impact of ERM adoption on leverage is unclear as companies that were previously at their target leverage level or/and with greater control of operational risks would suggest that the company could increase its debt capacity. In this study leverage is measure as total liabilities to assets:

Leverage= Total Liabilities / Total Assets (1)

Financial slack or cash availability provides a measure of a company's ability to continue its operation during a period of operating cash shortage. Financial slack measures the amount of highly liquid assets (such as cash or marketable securities) that the company has in hand that could be used to make up for any deficit in its operating cash flows. Companies adopting ERM may decide to increase its financial slack to provide a greater mitigation against financial distress, or similarly in leverage, may feel less financial slack is needed given that they are able to manage risks thoroughly. Financial slack is measures as the proportion of the company's assets that are cash or cash equivalents against its total asset, as shown below;

Slack = Cash and Marketable Securities / Total Assets (2)

This study also examines profitability measure as ERM adoption would produce a better overall management of the company. On the other hand, profitability could suffer, if ERM causes in an increase of operational costs. As with leverage, Pagach and Warr (2010) points out that the effect of ERM adoption on profitability is ambiguous as more coordinated management and loss avoidance may boost profits by reducing avoidable losses. Moreover, greater emphasis on risk management also may lead to a favorable outcomes and profitability may also be endogenously determined with ERM adoption. To measure accounting return, this study uses return on equity as shown in the following equation;

ROE = Net Income / Book Equity (3)

Asset Characteristics

The asset characteristics used in this study are those that provide information about the degree to which a company's assets are likely to be decreased in value upon financial distress. Such asset characteristic is opacity. Opacity is intangibles assets (such as, name brand and goodwill) that does not have a physical accounting value but nonetheless stated it is balance sheet. In DataStream, this is can be found in item WC02649. As news technology disperse rapidly, companies that derive much of their operating income from opaque assets would have difficulties in liquidating these assets at fair market value to avoid financial distress as information asymmetries would normally associated opaque assets and the relative lack of marketability for such assets. Opacity is the ratio of intangibles to total assets, as shown below;

Opacity = Intangibles / Total Assets (4)

The second asset characteristic examine in this study is firm's value or its growth options. Companies with growth options would have considerable amount of the firm's value tied to future income, but with unrealized current cash flows. Because of the uncertain nature of the payoff from such assets, the value of these investments is unlikely to be fully realized in bankruptcy. In this study, Q-ratio or approximate Q is use as proxy for company's growth options. This variable which is introduced by Chung and Pruitt (1994) is used and a result from the following formulas:

Approximate Q = [(MVE + PS + DEBT)]/Total Asset (5)

Where:

MVE : Year-end companies' share price and the number of common shares outstanding
PS : Value of the companies' outstanding preferred stock
DEBT : Value of the companies' short-term liabilities net of its short-term assets, PLUS the book value of the companies' long-term debt
TA : The book value of the total assets of the company

If, after adopting ERM, the company considers financial distress to be less likely, therefore, it is expected that investment in opaque assets and assets with growth options to increase.

Market Characteristics
Market characteristics provide information about the degree to which a firm's equity benefits from a reduction in the expected costs associated with financial distress. Previous work such as by Beasley, Pagach and Warr (2008) has examined the market reaction to ERM adoption, and it's consequently. However, this paper however does not include an event study style analysis as exact date of ERM adoption in this study' sample could not be ascertained.

3.0 Findings and discussions

Analysis for this paper starts with overall samples, Panel A for non-financial against Panel B for financial samples, test to whether MCCG 2007 produces different effect to that of MCCG 2000. Result from the use of independent samples t-test is shown in the following Table 2.

In Panel A, test output shows a significant reduction debt to asset ratio between MCCG2007 compares to MCCG2000. This improvement in ratio suggests that MCCG2007 has been successfully enhanced MCCG2000 and further decrease operational risk amongst local non-financial companies. Moreover, although this may not promote decline in venerability of bankruptcies as the ratios still in mid-30 percent, nonetheless it does to suggest that local companies are relying less on debt for their capital.

Table 2 Independent Samples t-Test between Non-financial and Financial Firms against MCCG2000 and MCCG2007

Variables	Mean Post MCCG 2000	Mean Post MCCG 2007	Changes	t-statistic
Panel A (Non-Financial Companies)				
Debt / Asset	.381501	.341983	-0.039518 **	-2.304
Slack	.373775	.360747	-0.013028	-0.647
Returns on Equity	.133532	.250478	0.116946	1.524
Opacity	.371331	.363271	-0.00806	-0.310
Approximate Q	.771154	.785775	0.014621	1.268
Panel B (Financial Companies)				
Debt / Asset	.138115	.153593	0.015478	0.417
Slack	.232830	.239404	0.006574	0.082
Returns on Equity	.007312	.082206	0.080894*	1.717
Opacity	.039333	.026534	-0.012799	-0.876
Approximate Q	.447433	.460756	0.013323	0.171

Note: *, **, *** indicates significance at the 10%, 5%, and 1% levels respectively.

Also shown in Table 2 Panel A is that changes in other variables are tested to be insignificantly different. Nonetheless, it should be noted that returns on equity (ROE) does shows a substantial improvement (11 percent) and on a whisk away to be tested significant. This welcome signs insinuate that comparing between these two MCCGs, local non-financial companies are able to increase investment returns to their shareholders the period. However, negative changes in slacks and opacity indicate that companies are holding less highly liquid assets and investing less in intangible assets though holding companies' value intact.

Output in Panel B suggest the obvious, the placebo sample shows almost no deviation in its variables with the exception of return on equity that is tested to be positively significant. As these companies, on most occasions, comply with local ERM regulations and well as internationally accepted BASEL II, their ratio are always at check. However, improvement in ROE may not be due to ERM, bearing in mind that year 2001 - 2002 is just post past 1997 Asian Financial Crisis where Malaysian bank's values as well as their equity value are at their lowest, but due to lower detonator.

As a whole, ratio performances against MCCG2000 and MCCG2007 implementation, the outcomes are encouraging especially for non-financial companies as nearly all ratios produced shows a justifiable result that can be rationalizes.

Further separate analysis are also conducted in this paper focusing on whether implementation of MCCG2000 and MCCG2007 itself produces favorable outcomes. As both MCCGs have its own ERM properties, with MCCG2007 as a revise version of MCCG2000, each MCCG should provide an improvement in post adoption ratios compares to pre-adoption ones. In this section, the implementation of MCCG2000, as shown in Table 3, starts the finding analysis and discussion on each MCCG.

Table 3 Panel A shows that non-financial companies recorded a positive significant increase in firms' value suggesting that the code have succeeded in directing companies to sustain its value. As MCCG2000 was adopted just only after 1997 crisis, it is a longed-for outcome. Although other variables does not show any significant positive result, nonetheless, ROE shows a good sign of improvement though tested to be insignificant.

Table 3 Paired Samples t-Test between Non-financial and Financial Firms against Pre and Post MCCG 2000

Variables	Mean Pre MCCG 2000	Mean Post MCCG 2000	Changes	t-statistic
Panel A (Non-Financial Companies)				
Debt / Asset	.404959	.394745	-0.010214	-0.482
Slack	.370755	.351900	-0.018855	-0.823
Returns on Equity	.028138	.111293	0.083155	1.532
Opacity	.378552	.344931	-0.033621	-0.966
Approximate Q	.727884	.758221	0.030337**	2.094
Panel B (Financial Companies)				
Debt / Asset	.144886	.179024	0.034138	1.398
Slack	.242681	.261903	0.019222	0.422
Returns on Equity	.005226	.018994	0.013768	0.233
Opacity	.030881	.008246	-0.022635	-1.538
Approximate Q	.436753	.468128	0.031375	1.097

Note: *, **, *** indicates significance at the 10%, 5%, and 1% levels respectively.

Financial companies' variables shown in Table 3 Panel B indicates that implementation of MCCG2000 does little to improve its standing. None of the variables tested to be significant. Furthermore, financial companies' leverage ratio shows a decline as during this period their assets value has substantially decline. Baring in mind that 1997 crisis has devastated the Malaysian banks assets value causing Bank Negara to instruct local banks to merge to avoid further complexities.

Summarizing the outcome from the MCCG2000 implementation, it is clear that non-financial companies have benefited more from it if were to compares to the financial companies.

A contrast in outcome from MCCG2000 implementation can be seen with the implementation of MCCG2007 as shown in the following Table 4. In Table 4 Panel A, none of non-financial companies' ratios shows sign of significant improvement or decline from MCCG2007 implementation. This suggests that the MCCG2007 implementation is indifferent in bringing or bridging out ERM practices amongst non-financial companies listed in Malaysian Bourse.

Table 4 MCCG 2007 Paired Samples t-Test between Non-financial and Financial Firms against Pre and Post MCCG 2007

Variables	Mean Pre MCCG 2007	Mean Post MCCG 2007	Changes	t-statistic
Panel A (Non-Financial Companies)				
Debt / Asset	.354271	.344533	-0.009738	-0.801
Slack	.359346	.369719	0.010373	0.599
Returns on Equity	.203738	.185560	-0.018178	-0.584
Opacity	.351205	.379912	0.028707	1.221
Approximate Q	.770110	.782832	0.012722	1.544
Panel B (Financial Companies)				
Debt / Asset	.175850	.160015	-0.015835	-0.647
Slack	.304655	.274589	-0.030066	-0.630
Returns on Equity	.044078	.078452	0.034374	0.599
Opacity	.026161	.026783	0.000622	0.089
Approximate Q	.463885	.413628	-0.050257***	-2.838

Note: *, **, *** indicates significance at the 10%, 5%, and 1% levels respectively.

Result on Table 4 Panel B, financial companies' ratios, also shows a similar pattern where most of its ratio fails to show improvement despite MCCG2007 is more stringently implemented. Moreover, its firm's value or growth potential ratio registers to be significantly negative implying that Malaysian banks financial sustainability is in a decline and contradict to MCCGs objectives. Nonetheless, the writers strongly believe that this occurrence is not due to failure of MCCG2007 as Malaysian financial companies are well regulated and monitors (locally and globally), hence this can attribute to 2007 financial crisis, where most of Malaysian banks and financial companies' asset lies globally as per reason of geographical assets diversification.

As a glance, implementation of MCCG2007 seems to have an insignificant impact to ERM practices to both non-financial as well as the financial companies. Nonetheless, one cannot rule out that lesson learned from 1997 crisis have matured most Malaysian Bourse listed companies in their governance and financial decisions, hence the revise code only does little as to give a significant impact to an ongoing ERM practices.

As a summary, MCCGs has indeed achieve its objectives in embracing/enhancing ERM practices by Malaysian Bourse listed either non-financial or financial companies with non-financial companies showing getting most of it especially during MCCG2000. Financial companies have been foreseen not to be significant affected by MCCGs as these companies are continuously confined to rules and regulations set by Securities Commissions, Bank Negara and BASEL II.

4. Conclusions

The aim of this paper is to highlight the impact of MCCGs implementation to non-financial and financial companies listed in the Malaysian Bourse. As MCCG2000 being the first time of such code been implemented in local financial settings, its impact were thought to be lesser to that of MCCG2007 (a revise version from

MCCG2000). At a glance, comparative test result suggests that MCCG2007 does produce the desired outcome, as non-financial leverage ratio is significantly lower after the implementation of MCCG2007. However, a refine examination reveals that MCCG2000 produces better result as non-financial companies firms' value has improve upon the first code implementation.

Overall, it is found that both MCCGs do not improve ERM practices in Malaysian Bourse listed financial companies with test result from later code reveals that financial companies firms' value has decline since the code implementation. Nonetheless, the reason being as such is contributed by other external financial factor rather than the implementation of the code itself. Last but not least, is that thought this paper is only being an initial analysis, it has some similarity to Pagach and Warr (2010) where their study also finds little impact from ERM implementation to a wide spectrum of firm variables.

End Note:

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