Do Firms With Standalone Risk Management Committee Have Better Performance than Those With Combined Committee?

Naqiah Awang[1*], Fatin Adilah Razali[2], Shafinaz Lyana Abu Talib[3]

[1]Faculty of Accountancy
Universiti Teknologi MARA Pahang, 27600 Raub, Pahang, Malaysia
[2,3]Faculty of Accountancy
Universiti Teknologi MARA Selangor, 42300 Bandar Puncak Alam, Selangor, Malaysia
naqiah0026@uitm.edu.my
[*]Corresponding Author

Received: 15 October 2022
Accepted: 31 January 2023
Date Published Online: 01 June 2023

Abstract: Malaysian Code of Corporate Governance 2017 has introduced the Step-Up Practice 9.3 to set up a focused, standalone Risk Management Committee among large, listed firms to combat risk issues in minimizing business losses caused by changes in the business landscape at unprecedented speed. However, the formation of this standalone committee as part of the governance monitoring mechanism is quite expensive making listed firms carefully evaluate its effectiveness. To provide insight to the practitioners and regulators, this study aims to test if there is any significant difference in firm performance between firms with a standalone Risk Management Committee and those with a traditional combined committee. Secondary data were adopted from the top 50 largest listed firm's annual reports for 2018 and 2019. DataStream was used to gather data on firm performance. Man-Whitney U Test was run using SPSS 28 as a nonparametric statistical. Results uncovered a significant difference in firm performance between firms with a standalone Risk Management Committee and firms with a combined committee. However, combined committee firms were reported to have better performance. These findings provide insight into the Malaysian risk governance structure in responding to the Malaysian Code of Corporate Governance 2017. The regulator could use these findings to design a better risk mechanism for promoting a prosperous financial market

Keywords: Committee, Firm performance, Risk, Risk management

Introduction

A high profitable business is always associated with high levels of risk (Rimin, Bujang, Wong Su Chu, & Said, 2021). This is a common conception in financial and management accounting. Realizing the importance to manage risk effectively in grabbing the opportunities for higher returns, effective audit and risk management continuously become the highlight of every version of the best practice of corporate governance issue by the Malaysian Securities Commission in its series of Malaysian Code of Corporate Governance (MCCG). This may include the proper distribution of power and responsibilities in the board of directors (MCCG 2017, Paragraph 1.2) to ensure appropriate risk identification, risk assessment and risk strategies in facing unpredictable business challenges.

Being part of the internal control system, risk management practice should serve its purpose to deal with business uncertainty and challenges (Awang, Hussin, Razali, & Abu Talib, 2021), especially with the dynamic nature of business risks (Saeidi et al., 2021). Corporate firms nowadays are in high volatility than before due to globalization, geopolitical conflict, climate change, resource scarcity, health issues and dramatic changes in digitalization (Chua, 2016). In Malaysia, risk management practices were started in 2000 when MCCG first introduced the concept of risk management to be part of the general responsibilities of the board of directors. At that time, no specific guideline was available. However, in 2007, the second version of MMCG started to make it compulsory for listed companies to establish an internal audit committee to handle risk management issues. Moving forward, the guideline was improved in 2012 when more detailed guidelines were published by the Securities Commission requiring the listed companies to set up a sound risk management framework under its Sixth Principle.

Recently in MCCG 2017, large firms were encouraged to set up a standalone Risk Management Committee (RMC) to deal with risk-related issues denominated by independent directors. Independent directors are believed to reduce agency problems (Karim, Manab, & Ismail, 2020) arising from the separation of ownership and management of the listed firms including in risks aspect. With the upwards trend of corporate failures like Enron, WorldCom and 1 Malaysian Development Berhad, this agency problem will never come to an end (Rimin et al., 2021). A stronger and more appropriate governance system should be in place to instil back shareholder's confidence and trust in the board of director's conduct and practices that have been tarnished when the reality is revealed (Boudiab, Mehiaddine, & Abderrahmane, 2021; Halim, Mustika, Sari, Anugerah, & Mohd-Sanusi, 2017).

Regardless of the urgent need for a more accountable board, the cost associated to establish a standalone RMC as a governance monitoring mechanism is not cheap (Boudiab et al., 2021) and better coordination is needed to ensure it is not just an eye obscuring committee established merely with the purpose of compliance with the corporate governance best practices (Ghazieh & Chebana, 2021; Malik, Zaman, & Buckby, 2020). This encouragement is yet to be compulsory for Malaysian listed companies as Malaysia is practicing a principle-based approach that works on the basis of comply or explain, with any departure from the specific provision in MCCG. Hence the listed firms need to properly strategize their cost-benefits analysis to form this standing committee. With little attention given to examine if standalone RMC is effective and in supporting the cost-benefit analysis that should be well planned by the board, this study aims to examine if there is any significant difference in the firm performance with the establishment of focused, standalone RMC among the top 50 Malaysian largest listed firms after the recommendation is launched in 2017. The research question of this study is:

> Do firms with standalone RMC has better performance than those with the traditional combined committee?

Literature Review

Agency Theory

An agency problem arises from the separation of ownership between the shareholder who is the fund provider and the management team and the board of directors who act as the agent to run the business on behalf of the shareholders with the ultimate motive of profit maximization. However, this is not always the case as an agent might pursue their own interest.

Hence, strong governance is needed to align the interest of both parties (Rimin et al., 2021), including putting an internal supervision mechanism like RMC to reduce agency problems by performing monitoring and supervision on risks-related matters (Ghazieh & Chebana, 2021; Halim et al., 2017; Jia & Bradbury, 2020; Larasati, Ratri, Nasih, & Harymawan, 2019). The appointment of an independent director in RMC is very useful to act as a bias-free tool (Ishak & Mohamad Nor, 2017; Karim et al., 2020) to provide independent judgement in overseeing risk strategies execution. In these ways, agency problems could be reduced (Malik et al., 2020). Having RMC on board, recurring risk could be well-managed and catastrophic risk could be avoided hindering business to suffer huge losses hence producing better firm performance (Ghazieh & Chebana, 2021; Jia & Bradbury, 2021).

Combined Committee Vs Standalone RMC

Traditionally, the role to manage risks is parked within the AC custody known as the combined committee (Rimin et al., 2021). This is because risk oversight is seen as part of the internal control system of the companies and falls within AC's responsibilities to oversee and evaluate internal control procedures apart from monitoring and reviewing financial reporting and auditing process. That is why AC is the busiest committee with all these portfolios as reported by Bursa Malaysia (2021). These practices have been criticized to result in overburdened AC causing them to take risk issues lightly while focusing on improving financial reporting quality (Abdullah & Said, 2019). Given the dynamic nature of risks due to internal and external uncertainties, risks should be managed carefully to ensure business sustainability (Saeidi et al., 2021). Risk strategies that might be relevant today might not be relevant any longer tomorrow. Thus, the board needs to always review risk exposure as new risks arise and amend the suitable risk strategy to cope with the changes (Halim et al., 2017).

As recommended by the best practice of corporate governance, a focused, standalone RMC must be formed as risk overseeing is not a one-off process and need to be reviewed as frequently as possible. However, the formation of a standalone RMC has no use if it is established just to comply with the best practices without serving its ultimate objective (Awang et al., 2021; Malik et al., 2020). This internal monitoring mechanism should be well structured promoting diversity on the board with strong oversight functions in place.

Risk Management and Firm Performance

Limited previous studies on the impact of standalone RMC on firm performance revealed mixed findings based on the measurement used for firm performance. A study by Halim et al. (2017) reported firms with standalone RMC have better financial performance, measured by ROA with an effective risk management process in place. This focused committee allows directors to devote their full commitment and effort to anticipate all risks that might arise and come out with the appropriate risk strategies. Another study by Jia and Bradbury (2020) conducted on Australian listed firms uncovered companies with RMC perform better, with higher ROA and growth and lower probability of financial distress than firms with a combined committee.

Rimin et al. (2021) discovered a positive association between the establishment of standalone RMC and financial performance measured by Tobin Q, indicating better investor valuation and confidence in companies with properly structured risk mechanisms. However, ROA is found to be negatively correlated to standalone RMC due to lack of monitoring roles by independent non-executive directors. The appointed directors have lack of technical knowledge and experience to undertake proper supervision of the risk management process.

Due to limited studies performed on the impact of the establishment of standalone RMC on firm performance, this study also reviews prior related literature on the effectiveness of Enterprise Risk Management (ERM) on firm performance. In the UK, Malik et al. (2020) found out that FTSE350 listed firms' performance (measured by Tobin Q) improves with the establishment of strong governance of the risk committee. Applying substance over form concept, he further suggested a mere formation of a risk committee will do nothing good to firm performance unless with a properly structured and governed risk committee, a committee with a proper monitoring process comprises of financial experts and promotes gender diversity in the board structure. In the Europe context, Ghazieh and Chebana (2021) report a significant positive relationship between risk management system on European large, listed firm performance (proxied by ROA, Return on equity and Tobin Q). She added that a specialized team set up to manage risk matters with proper risk strategies can be successfully executed in responding to the uncertain business environment and effective management of the company.

The following hypothesis is developed for this study:

H1: There is a significant difference in the firm performance measured by ROA between firms with established standalone RMC and firms with combined committee.

Methodology

Research Method and Sample Selection

The quantitative study was conducted to examine if there is any significant difference in the firm performance with the establishment of focused, standalone RMC among the top 50 largest listed companies.

The study population comprises of listed firms of all industries in Bursa Malaysia excluding financial institutions. The purposive sampling was adopted to include only the top 50 Malaysian largest listed firms by market capitalization in reference to FBM KLCI. This is because larger firms face greater risks and challenges to be dealing with, thus have a solid reason to set up a costly focused, standalone RMC (Halim et al., 2017) Even the best practices of corporate governance acknowledge that large firms face greater demand from the shareholder to carefully monitor and address business risks that might arise (Securities Commission, 2017). The observation was made for two consecutive years (2018 and 2019) resulting in a total of 100 samples. These years were chosen as the latest years after the recommendation made to establish a focused, standalone RMC by the Security Commission.

Data Collection and Data Analysis

DataStream was used to gather data on firm performance measured by Return on Assets (ROA). The data on the establishment of RMC was collected from annual reports of sampled firms obtained from Bursa Malaysia's official website. Content analysis was performed to identify whether the selected firms had established a focused, standalone RMC during the year. The data were obtained primarily from the company governance framework and corporate governance overview statement.

The dichotomous variable of "1" was used to represent a listed firm with a focused, standalone RMC and '0" for a firm with a combined committee. These two data sources can be considered as secondary data with high reliability as the data has been audited. Once the complete data were compiled, they have been entered into Statistical Package for the Social Science (SPSS) software 28 to produce results on descriptive statistics analysis, normality test and independent sample t-test. The summary of variable measurements adopted by this study were presented in Table 1**.**

Table 1. Summary of Variable Measurements

Variable	Acronym	Measurement of Data	Prior Study	Source of Data
Dependent Variable: Company Performance (Return on Asset)	ROA	Earnings before interest and tax / Total assets	Ghazieh and Chebana (2021), Jia and Bradbury (2021) and Saeidi et al. (2021)	DataStream
Independent Variable: Establishment of RMC	RMC	1 = company with focused, standalone RMC 0 = company with combined committee	Rimin et al. (2021)	Annual Report (Content Analysis)

Valuation of firm performance can be in many forms depending on the purpose of the study. This current study employs the most traditional measure of performance which is the return on assets (ROA) as it has been used extensively by prior studies to measure actual historical performance (Ghazieh & Chebana, 2021; Halim et al., 2017; Jia & Bradbury, 2021; Rimin et al., 2021; Saeidi et al., 2021). ROA measures the amount of earnings generated from the invested capital assets. Higher ROA implies better use of assets to generate earnings for the shareholder return. As this study covers a short period of observation of two years, historical performance measure like ROA is more meaningful for the evaluation.

Findings and Discussion

Frequency Statistics

Frequency statistics were carried out on the adoption level of RMC among large, listed firms to see firms' acceptance towards the recommendation made in MCCG 2017.

Table 2. The Adoption of RMC Establishment

	2018 (N=50)		2019 (N=50)		Entire sample (N=100)	
	Frequency	Percent	Frequency	Percent	Frequency	Percent
Combined committee	25	50	21	42	46	46
Standalone RMC	25	50	29	58	54	54
Total	50	100	50	100	100	100

The adoption level of RMC establishment among the top 50 largest listed firms in 2018 and 2019 were presented in **Table 2**. Following the Step-Up Practice 9.3 of MCCG 2017, 54% of the firms have formed a standalone RMC to handle their risk management activities. They seem to welcome this recommendation as more firms started to establish a standing RMC in 2019 (58%) as compared to 2018 (50%).

Data Screening

Data screenings were performed to ensure the data set are free from missing values and normality tests were run to conclude the normality of data for dependent variables before further tests of significant difference were decided. As the sample size can be considered larger as it exceeds 50 (N=100), the Kolmogorov-Smirnov test was used to conclude its normality as presented in **Table 3**.

Table 3. Test of Normality

	Kolmogorov-Smirnov[a]			Shapiro-Wilk		
	Statistic	df	Sig.	Statistic	df	Sig.
ROA	.169	100	<.001	.843	100	<.001

a. Lilliefors Significance Correction

Based on **Table 3**, it is confirmed that the ROA is not normally distributed since the sig. p-value <0.05. According to Pallant (2010), this is common in large sample sizes utilizing financial data. The shape of histogram that skewed to the right supported ROA distribution is not normal.

Descriptive Statistics

Descriptive statistics for the continuous dependent variable, ROA were presented in **Table 4**. On average, firms with combined committees have a higher positive ROA of 11.59 as compared to those with standalone RMC which only show a positive ROA of 6.36. This is a quite surprising finding as it deviates from the early expectations. Its standard deviation also is very high demonstrating a high variation of ROA in both committees.

Table 4. Descriptive Statistic on ROA

		N	Mean	Standard Deviation	Std. Error Mean
ROA	Combined committee	46	11.59	10.49	1.55
	Standalone RMC	54	6.63	6.36	0.87

Man-Whitney U Test

As the data is not normally distributed, a nonparametric test of Mann-Whitney U test for two independent sample medians was run to examine if there is any significant difference in firm performance measured by ROA between a firm with focused, standalone RMC and those with a traditional combined committee.

Table 5 represents the result of the Mann-Whitney U Test. Based on the test statistic in Table 5, the sig. value for ROA is <0.05 (p-value =0.023) implying there is a significant difference in median of ROA between firms with focused, standalone RMC and those with traditional combined committee. Therefore, H1 is accepted.

Table 5. Mann-Whitney U Test

Test Statistics[a]

	ROA
Mann-Whitney U	914.000
Wilcoxon W	2399.000
Z	-2.268
Asymp. Sig. (2-tailed)	.023

a. Grouping Variable: Combined or Standalone

Ranks

	RMC	N	Mean Rank	Sum of Ranks
ROA	Combined committee	46	57.63	2651.00
	Standalone RMC	54	44.43	2399.00
	Total	100		

However, firms with a combined committee show a higher mean rank of ROA of about 57.63 as compared to firms with focused, standalone RMC with ROA of only 44.43. This demonstrates that firms with combined audit and risk committee have fully utilized the expertise and experience of their AC members and benefited from the synergies (Awang et al., 2021) offered by practicing traditional combined committee to maximize shareholder wealth by generating better ROA. This finding is not in line with the previous findings by Jia and Bradbury (2021), Ghazieh and Chebana (2021) and Halim et al. (2017) who discovered firms with standalone RMC have better ROA.

It might be too early to investigate how efficient these focused, standalone RMC in contributing towards better ROA as the encouragement for its formation just takes effect through MCCG 2017. 2018 and 2019 might be the adaptation period for these listed firms to strategies their governance mechanism and listed firms need time to execute strong and structural RMC (Rimin et al., 2021). Moreover, companies that just started to segregate their risk management from AC might just do it to be seen as complying with the best practice of good corporate governance without really formulating how the risks practices are executed (Malik et al., 2020). For instance, the lack of monitoring roles by independent non-executive directors caused more costs to be incurred in facing the risks attached hence resulting in lower ROA among companies with standalone RMC.

Conclusion

The recommendation made by MCCG to establish a standalone RMC is absolutely a good move to strengthen the corporate governance in listed companies by having a focused and proactive team to manage risk-related issues. However, as the encouragement is still voluntary, there are no proper guidelines introduced to guarantee the proper execution of this Step-Up Practice on risk management conduct among Malaysian large, listed companies. Therefore, it can be seen as a weakness to apply principles-based corporate governance because there is always room for flexibility when a specific guideline is not provided. The regulator could use these findings to design future risk governance mechanisms in strengthening Malaysian corporate governance to enhance shareholder confidence in the Malaysian financial market. The period covered in this study has validated the need for adjustment and adaptation to the board structure for firms that decided to segregate the risk management role to be in charge by a standing RMC.

This empirical study has provided insight into Malaysian large, listed firms' governance structure, particularly on their risk management practices. The operationalization and execution part are always the most difficult part to be implemented with the absence of proper formulation in risk strategies. The focus of this study is to examine if there is any difference in firm performance if the standalone RMC were established. However, due to time constraints, only two years were observed after MCCG 2017 was launched. The RMC structure was also ignored in this current study. Filling up the gap, future studies might consider drilling down the RMC structures including examining how RMC structure could have an impact on firm performance. The number of members on the board, number of meetings held per year, diversity of the board and members' knowledge and experience can be the deciding factors to be included in future research.

Acknowledgements

The authors thank Allah, the Lord of the universe, who always bestows his grace along with guidance so that the authors can complete the study. Special thanks to all authors for their contribution, time and commitment that made the study possible.

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