ASSESSING THE RELATIONSHIP AMONG CORPORATE GOVERNANCE, SUSTAINABILITY DISCLOSURE AND FINANCIAL PERFORMANCE

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ABSTRACT

Corporate governance is a monitoring mechanism that is created because of the possible conflict of interest that results from the separation of ownership and control between the shareholders and the board of directors. Control and procedures of companies can be improved given the introduction of corporate governance. Previous literature supports that corporate governance is an effective corporate governance that helps companies to increase the value of the firm, attract foreign investors, and improve quality of reporting. Previous studies also indicate that investors are drawn to companies that are actively involved in sustainability activities. However, real commitments from Malaysian companies for sustainable developments are questionable. This study identifies corporate governance mechanisms from agency theory perspective, in assessing its relationship to the financial performance, and sustainability disclosures. The theoretical contribution of this study is by the extension of previous studies by exploring the relationship and examining the mediating effect in sustainability disclosures between corporate governance and financial performance.

Keywords: corporate governance, sustainability disclosures, global reporting initiative (GRI), financial performance

ARTICLE INFO

Article History :
Received : 8 May 2016
Accepted : 5 October 2016
Published : 30 December 2016

INTRODUCTION

Companies are usually formed with an ultimate objective of producing maximum returns for its shareholders. However, shareholders manage companies unnecessarily. The individuals who operate the company, such as managers, chief executive officers, and directors, may not necessarily hold shares in the company. As such, a separation of ownership and control occurs. Therefore, the power of setting company policies and making operational decision lies in the hands of the board of directors although shareholders represent the rightful owner of a company (Cheah & Lee, 2009). The separation of ownership and control causes conflict of interest between the shareholders and board of directors. In principle, all operational decisions should be made in the best interests of the shareholders because they are the rightful owners of the company. However, this may not be the case. Some of the decisions made may be in the best interest of the board of directors instead. As such, this results in conflict of interest between the board of directors and the shareholders. Therefore, corporate governance is introduced to improve the monitoring mechanism for the benefit of the shareholders.

Corporate governance was first introduced in Malaysia after the 1997 Asian financial crisis with the establishment of High Level Finance Committee in 1998. The committee was established to address corporate governance issues and to increase investors' confidence, which was then extremely low. In 1999, the High Level Finance Committee report was issued in providing a framework on corporate governance to companies. Revisions were then made to further strengthen the framework on corporate governance. In 2000, Malaysian Code on Corporate Governance (Code) was issued and was then revised into the 2007 Code. In 2011, Corporate Governance Blueprint 2011 (Blueprint) was released. With the revisions, the focus of corporate governance shifted. For instance, revisions made in the 2007 Code have further strengthened the roles and responsibilities of the board of directors and audit committee. The Blueprint reminded board of directors and shareholders on the importance of ethical and sustainability issues. The most recent revision was made in 2012 where the Malaysian Code on Corporate Governance 2012 (MCCG 2012) was issued. In MCCG 2012, the board of directors is once again reminded to act in the best interest for the company and shareholders. Furthermore, interest of other stakeholders is not to be neglected. MCCG 2012 further stressed on the importance of directors being ethical and of making sustainable decisions in the pursuance of desired financial returns.

PROBLEM STATEMENT

Shareholders today do not only expect good financial returns from companies, but also expect companies to perform its corporate social responsibility by involvement in sustainability activities. When such involvement occurs, disclosures of the involvement can be made in the annual reports of the company. The number of companies making sustainability disclosures in their annual reports has increased in past years. However, the real commitments from Malaysian companies are questionable. PricewaterhouseCoopers conducted a survey in 2014 as regards sustainability strategies of companies. Only 35% of the companies surveyed were found to have dedicated teams to drive and monitor the sustainability strategies of the companies, thereby indicating that that the management of the company lacks dedication in their sustainability involvements.

In 2002, a professional body, namely, The Association of Chartered Certified Accountants (ACCA), launched an annual award in recognition of good sustainability reports by companies. The award was named “ACCA Malaysia Environmental and Social Reporting Awards” (MESRA). MESRA also aims to cultivate Malaysian companies in improving corporate social responsibility (CSR) disclosures of companies. In 2009, the award was renamed to “ACCA Malaysia Sustainability Reporting Awards” (MaSRA). The new name covers broader disclosures in the aspects of society, economy, and environment. Although the award had been carried out for the 8th cycle in 2009, MaSRA had only solicited 56 entrants, which represented only 6.1% of the total listed companies in Bursa Malaysia (911 as of December 31, 2013). In addition to efforts from ACCA, the local authority named Securities Commission Malaysia (SCM) has also attempted to emphasize the importance of corporate growth in a sustainable manner. In 2011, SCM issued Blueprint, which advises the Board of Directors to oversee sustainability strategies in taking care of stakeholders’ interest. However, the low participation rate in MaSRA in 2013 and 2014 is discouraging.

RESEARCH OBJECTIVE

This research aims to examine the relationship among corporate governance mechanisms, sustainability disclosures, and financial performance in Malaysian listed companies.

SIGNIFICANCE OF THE STUDY

The theoretical contribution of this study is to extend previous research by exploring the relationship among corporate governance, sustainability disclosure, and financial performance. Much of previous research focuses on the relationship of corporate governance towards financial performance, and sustainability disclosure towards financial performance separately. This study will also contribute to the existing literature by providing empirical data. This study will then benefit the practitioners or the company leaders by providing them information on the usefulness of corporate governance and environmental disclosures towards the bottom-line of the companies (i.e., financial performance). Today, expectations of stakeholders on companies have shifted from pure financial gains to broader aspects, such as expecting companies to be involved in sustainability activities. Therefore, company leaders must aware of the effect of corporate governance and sustainability reporting towards the financial performance of the company.

THEORETICAL FOUNDATION

Agency theory is chosen for this study because it is frequently used in previous literature (Mazlina & Ayoib, 2011; Mohd Hassan, Rashidah, Nadiah, & Sakthi, 2006; Mohd Hassan, Rashidah, & Sakthi, 2008; Rachagan & Satkunasingam, 2009; Shamsul, Nor Zalina, & Mohamad Naimi, 2010) this study also investigates the association between direct and indirect managerial shareholdings with agency costs. Design/methodology/approach \u2013 The data for the study is obtained from two sources, namely primary (questionnaire in explaining the principal-agent relationship between the shareholders and the boards of directors. According to Htay, Syed Ahmed, and Ahamed Kameel (2013), concepts from agency theory are frequently used in United Kingdom and Malaysia. Agent refers to the person appointed by the principal. In this study, agent refers to the board of directors, and the principal refers to the shareholders of the company. The board of directors (agent) owes fiduciary duty to the shareholders (principal). According to Blueprint, fiduciary duty means each individual director is acting in good faith, without self-interest, and applies reasonable degree of care and diligence to the shareholders. Therefore, the director is expected to act in the best interest of the company and its shareholders.

Alchian and Demsetz were the first to introduce agency theory in 1972 and further developed by Jensen and Meckling in 1976 (Htay, Salman & Meera, 2013). According to Jensen and Meckling (1976), separation of ownership and control causes conflict of interest. The appointed board of directors may make operational decisions for their own interest instead of the shareholders' best interest. Both the principals and agents are assumed as utility maximizer. Therefore, the board of directors have no reason to act in shareholders' best interest. As a result, agency costs occur, which comprises cost of monitoring, bonding, and residual loss (Jensen & Meckling, 1976). Agency theory states that when conflict of interest is eliminated, the agency costs are reduced and hence, performances of companies are improved (Welbourne & Cyr, 1996).

Together with the agency theory, stakeholder theory will be used in explaining how companies responded to the increasing pressures from its stakeholders. Without the demands and pressures from stakeholders, companies may not report disclosures on sustainability involvements in their annual reports. Several previous studies have applied stakeholder theory in explaining the increased sustainability involvements of companies (Goh, Suhaiza, & Nabsiah, 2006; Low, 2015; Yusoff, Yusoff & Lehman, 2007; Wong & Jamilah, 2010) Malaysia, were conducted and analysed through within-case and cross-case analysis. Three research questions focusing on aspects of CSR (internal and external. Freeman first introduced stakeholder theory in 1984 (Lansiluoto, Jarvenpaa & Krumwiede, 2013). Friedman & Miles (2006) defined stakeholders as an individual or a group of people who can be affected by the decisions of the company. Stakeholders comprise shareholders, customers, suppliers, managers, lenders, and general public. Yusoff, Yusoff & Lehman (2007) explained that companies have accountability in making disclosures to stakeholders because the stakeholders rely on the information disclosed to make business decisions.

According to Htay, Salman and Meera (2013), stakeholders are as important as shareholders. Stakeholders hold the power in influencing the directions and strategies of the companies.

CORPORATE GOVERNANCE

According to Cheah & Lee (2009), a global standard definition for corporate governance is lacking. This study adopts the definition of corporate governance from MCCG 2012 guidelines. In Malaysia, listed companies are governed by MCCG 2012. Considering that this study is conducted in Malaysia, the use of its local authority definition is well-justified.

MCCG 2012 defined corporate governance as "The process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholder value, whilst taking into account the interests of other stakeholders."

Many corporate governance mechanisms are used. In this study, four corporate governance mechanisms are selected using agency theory as follows: (1) proportion of independent directors, (2) non-duality of chief executive officer (CEO) and (3) board size.

HYPOTHESES DEVELOPMENT

Proportion of Independent Directors and Financial Performance

The board of directors (board) forms an internal control mechanism from the agency perspectives to address the conflict of interest between the principal and its agent (Ujunwa, 2012). As such, such control mechanisms are essential in measuring the relationship of Board characteristics and financial performance. According to MCCG 2012 (Principles 3, Recommendation 3.5), having the majority of independent directors in the board is vital to the company, thereby ensuring a balance of power and authority among the board members. Germain, Galy & Lee (2014) defined executive directors as full time directors who are employed by the companies. Generally, executive directors made daily operational decisions; therefore, executive directors are not considered independent directors. Independent directors also refer to non-executive directors who are not involved in making daily operational decisions.

Bar-Yosef and Prencipe (2013) found that high board independence improve corporate governance quality. A good proportion of independent directors over the total directors in the board leads to improved corporate governance monitoring quality (Akhtaruddin & Hasnah, 2010). High board independence also deters self-interest actions (El-Chaarani, 2014). Based on agency theory, when corporate governance monitoring quality improves, the financial performance will improve. This claim is supported by many previous studies that found that proportion of independent directors and financial performance has a significant and positive relationship (Mashayekhi & Bazaz, 2008; Reddy, Locke, & Scrimgeour, 2010). However, results from other previous studies are contradicted. For instance, Sheikh, Wang & Khan (2013), in a study in in Pakistan, found that the proportion of independent directors and financial performance has a significant and negative relationship. The arguments above lead to the following proposition:

$H1_a$: A larger proportion of independent directors will improve the financial performance of Malaysian listed companies.

Non-Duality of Chief Executive Officer (CEO) and Financial Performance

Non-duality of CEO refers to the positions of CEO and board chairperson held by two separate individuals. MCCG 2012 in Malaysia (Principles 3, Recommendation 3.4) recommends the practice of non-duality of CEO. In other words, a person who holds the position of CEO should not be the chairperson to the board. By separating these two positions, responsibility borders are clearer and thus enhances the accountability of the board (MCCG 2012). However, MCCG 2012 did not make mandatory separation of these two positions. Companies that do not follow the recommended practice will have to disclose its justification at their annual report.

Previous literature revealed conflicting results over the relationship between non-duality of CEO and financial performance. For instance, Andreou, Louca, & Panayides (2014) conducted a study and found that non-duality of CEO negatively related to financial performance. Therefore, non-duality of CEO worsens the financial performance of the company. This finding opposed the agency theory, which suggests the non-duality of CEO strengthens the monitoring and controlling mechanism of the board. This strengthening in turn improves the financial performance of companies. Andreou et al. (2014) argued that the findings can be due to the specific maritime industry studied, which can then be different from other industries in general. Ujunwa (2012) another study and found that separation of CEO and board chairperson has positive relationship with financial performance. This result is supported by the agency theory. However, Ujunwa (2012) emphasized that the non-duality of CEO may not be useful for new firms because separation of these two positions may not allow the flow of good information to board members. As a result, valuable discussion between the CEO and board members may be deterred and hence, financial performance can be hindered. However, the hypothesis developed for this study follows the recommendation of MCCG 2012, which supports the non-duality of CEO as follows:

$H2_a$: Non-duality of CEO will improve the financial performance of Malaysian listed companies.

Board Size and Financial Performance

Board size refers to the total number of directors in the board of directors (board) within a company. Board size is also one of the corporate governance mechanisms that are regularly examined by previous literature in relation to financial performance. According to Ebaid (2013), board size may influence the board's monitoring effectiveness. Large and small board sizes have their own advantages. For instance, large board size provides a large pool of expertise, thereby enhancing resources availability (Ebaid, 2013). However, smaller board size has its advantages, such as less free riding among its board members and lower coordination costs (Raheja, 2003).

Ujunwa (2012) stated that board size has a positive relationship with financial performance. However, Ujunwa (2012) asserted that when board size increases, the effect on financial performance decreases. Another previous study found board size to be a significant variable in influencing the return on assets (Andreou, Louca & Panayides, 2014). However, the study focused on maritime firms. Contradicting results were also found where the board size and financial performance do not have any significant relationship (Guo & Kumara, 2012; Reddy, Locke & Scrimgeour, 2010). Non-directional hypothesis is proposed for this study because of the conflicting results from past studies:

$H3_a$: Board size has a significant effect on the financial performance of Malaysian listed companies.

Corporate Governance and Sustainability Disclosures

MCCG 2012 (Principles 1, Recommendation 1.4) recommends the board of directors to ensure strategies of the companies are in place for promoting sustainability activities. Although one of the benefits of corporate governance is the improvement of the voluntary disclosures of companies, this study aims to examine the relationship between corporate governance mechanisms and sustainability disclosures. Sustainability disclosures refer to disclosures made by companies in their annual reports as regards the strategies of the company, involvements, and implementation of sustainability activities. According to Montiel (2008) and Petrini & Pozzebon (2010), CSRs and corporate sustainability (CS) are similar. CSR and CS cover three dimensions of economic, social, and environmental responsibility.

Proportion of Independent Directors and Sustainability Disclosures

Darmadi and Sodikin (2013) affirmed that independent directors may promote or lessen voluntary disclosures of companies. Therefore if a larger proportion of independent directors promotes information disclosures, more information will be disclosed by companies voluntarily. However, if a larger proportion of independent directors plays substitutive roles, voluntary information disclosed will be reduced or minimized.

Existing empirical studies provide contradicting results. Darmadi and Sodikin (2013) conducted a study on family-controlled firms and found that independent directors are negatively associated with voluntary disclosure. The reason towards this finding is the nature of firms studied. Darmadi and Sodikin (2013) explained that independent directors may lack independence because the study was based on family-controlled firms. Decision-making can be dominated by management. Another study conducted by Chen & Jaggi (2000) in Hong Kong has found that a proportion of independent directors positively improves the financial disclosures. Therefore, a larger proportion of independent directors leads to disclosures that are more comprehensive and are on a voluntary basis. Patelli and Prencipe (2007) found another positive association between the proportion of independent directors and the level of voluntary disclosure. Given that MCCG 2012 promotes a larger proportion of independent directors, as well as greater disclosures on sustainability issues, the following hypothesis is developed:

$H4_a$: Larger proportion of independent directors will improve the sustainability disclosures made by Malaysian listed companies.

Non-Duality of CEO and Sustainability Disclosures

Non-duality of CEO means the CEO is not acting as the chairperson in the company's board of directors of companies. As a result, the board could face less influence from the CEO and thus provide better decision-making. Giannarakis, Konteos and Sariannidis (2014) explained that duality of CEO (i.e., the position of CEO and the board chairperson is held by the same individual) will diminish the monitoring role of the board. The study conducted by Giannarakis, Konteos and Sariannidis (2014) was on 500 leading companies in United States. Although the study found that CEO duality is an insignificant determinant for sustainability disclosure, the duality does influence the extent of social information level. By contrast, Bar-Yosef and Prencipe (2013) found that non-duality of CEO will improve board independence, which in turn, improves the quality and transparency of financial reports. Therefore, the study emphasized the importance of non-duality of CEO that will strengthen the corporate governance system. As a result, disclosures and reports will be more transparent.

Given that MCCG 2012 recommends the non-duality of CEO as the best practice for Malaysian listed companies, the hypothesis developed for this study is in the same direction as MCCG 2012. This leads to the following hypothesis:

$H5_a$: Non-duality of CEO will improve the sustainability disclosures made by Malaysian listed companies.

Board Size and Sustainability Disclosures

This study also proposes to examine the relationship between board size and sustainability disclosures. The size of the board within the company refers to the total number of directors in the board of directors. Board size can be large or small. Sustainability disclosures represent one of the voluntary disclosures made by companies. Some previous literature suggested that board size has a significant association with sustainability disclosures One example is Ahmed Haji (2013). The study was carried out in Malaysia using legitimacy theory. The findings found that sustainability disclosures made by Malaysian companies were increased as an attempt in reducing legitimacy gap with the public. The study also affirmed that the relationship between board size and financial performance was further strengthened by the revisions in 2007 Code.

This proposed study attempts to extend previous literature by examining the relationship of the board size and financial performance using the stakeholder theory. However, Roshima, Yuserrie, and Hasnah (2009) revealed that board size has no significant relationship with sustainability disclosure. Although both studies were conducted under the Malaysian context, contradicting results were still revealed. Given that larger board size may result in more conflict and increases communication problems between the board members, the following hypothesis is developed:

$H6_a$: A negative relationship occurs between the board size and level of sustainability disclosures by Malaysian listed companies.

Sustainability Disclosures and Financial Performance

Companies' sustainability policies and implementations should be disclosed in their annual reports and websites. As explained by MCCG 2012, perceptions of the public, investors, and potential investors towards the company can be enhanced by companies' sustainability involvement. As explained by Garrison, Noreen, Brewer, Cheng & Yuen (2015), companies' social performance can affect their companies' financial performance. For instance, companies with poor social performance may be alienated by customers; thus, companies' revenues and profits will suffer. Although Garrison, Noreen, Brewer, Cheng and Yuen (2015) pointed that initial costs on sustainability activities will be incurred by companies, the savings gained would be greater.

Previous literature, such as Iatridis (2013), supported the positive relationship of environmental disclosures and financial performance. With high quality environmental disclosures, a company is perceived to have strong corporate governance and hence the company will face fewer difficulties in raising funds for operation (Iatridis, 2013). Litt, Sharma and Sharma (2014) conducted a study in the United States and concluded that socially responsible companies engaged in pollution prevention and/or climate protection initiative will likely to report higher profits because of real economic gains. These companies are unlikely to manipulate their profits. However, contradicting results were found by other previous literature. For instance, Makni, Francoeur and Bellavance (2009) found that corporate social performance of companies does not have a significant relationship with financial performance. However, a hypothesis developed for this study follows the recommendation of local authorities that promotes performing sustainability activities within companies.

$H7_a$: Sustainability disclosures will improve financial performance of Malaysian listed companies.

Mediating Effect in Sustainability Disclosures between Corporate Governance Mechanisms and Financial Performance

Previous studies that examine the mediating effect in sustainability disclosures between corporate governance mechanisms and financial performance are limited. However, Che Haat, Abdul Rahman and Mahenthiran (2008) conducted a study in Malaysia and found that transparency disclosure is not a significant mediating variable between corporate governance and financial performance. The study selected other corporate governance mechanisms, such as ownership structure and audit quality. The theory used in the study are also agency theory and resource dependence study. This proposed study aims to expand the previous study by selecting other corporate governance mechanisms focusing on board of directors because they are important corporate governance device (Ujunwa, 2012). This study also aims to explain the relationship between these variables using agency and stakeholder theories. The following hypothesis is developed:

$H8_a$: Significant mediating effect occurs in sustainability disclosures between corporate governance mechanisms and financial performance.

THEORETICAL FRAMEWORK

The above discussions lead to the following theoretical framework:

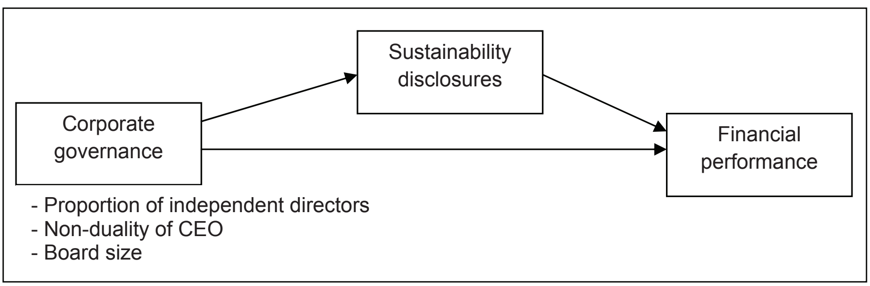

Figure 1: Theoretical Framework

CONCLUSION

This study sought to identify the corporate governance mechanism that can improve sustainability disclosures of corporations. This study will also examine the relationship between these corporate governance mechanism and financial performance of Malaysian listed companies. The effect of sustainability disclosure towards financial performance will also be examined. The findings of this study will provide corporate leaders, such as chief executive officers and board of directors, to ascertain the effect of corporate governance and the sustainability disclosures towards the companies' financial performance. The findings will also aid the policymakers as it will highlight those significant corporate governance mechanisms. Lastly, this study aims to provide empirical evidence to literature after samples are collected among Malaysian listed companies.

ACKNOWLEDGMENTS

The authors would like to thank Universiti Tunku Abdul Rahman (UTAR) for giving them a UTAR Research Grant (IPSR/RMC/UTARRF/2014-C2/N03) to undertake the study.

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