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EXPLORATORY STUDY IN MODELING A PERFORMANCE INDEX FROM HETEROGENEOUS RISK AND GOVERNANCE STRUCTURE THAT PROMOTES GOING CONCERN AMONG MALAYSIAN FIRMS

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ABSTRACT

This research explores the plausibility of constructing a performance index of risk and governance structure which will characterize both successful and unprofitable companies. Risk is expected to be examined pertinent to liquidity risk, financial risk and strategic risk. In a construct that represents each risk, a measurement ratio will be developed into an index. An estimated 390 companies of the estimated 1000 companies listed at Bursa Malaysia from 2001 to 2014 are used. The reduction in the number of companies compiled, has been due to a substantial amount of insufficient information which may lead to severe unbalanced data when the panel is regressed. A panel estimation will be run on risk and governance construct, of which an output with higher cumulative index may match viable companies. Companies with lower cumulative index will represent unprofitable companies. The cumulative index on risk and governance that are developed will provide a general snapshot or overview on what level of risk and governance structure the company can adopt if it has to be sustainable as a going concern company.

Keywords: Performance Index; Risk; Governance; Sustainable; Going Concern.

1. BACKGROUND

Establishment of companies started from a simple objective of reaping miniature profit. It is indeed a natural characteristic of small and medium sized companies, with few directors and venturing into multitude of business enterprise. There is without doubt there is no element of certainty that

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all the business ventures are going to be successful. Many private owned companies which start from small may decide to grow big and take a more pro-active approach by setting target to become listed as public limited company in the future. The silver linings of becoming public would allow company to have easy access to funding through direct or indirect investment from potential shareholders. Others may not be successful and will continue to support working capital requirement and business growth through traditional debt financing. However, those public listed firms are certainly not going to be rewarded with a smooth ride, but are expected to compete vigorously in many aspects of business activities and are being exposed to high but diversity of risks.

Business with little component of risk is saturated. Companies which are not willing to go one step forward by taking more risk are expected to be contended with low or minimum returns. Risks produce expected outcomes which are uncertain or breed events which may not help the company to achieve the organizational objectives (Noor & Abdullah, 2014). The attainment of the organizational objectives may be reflected in a company which is viable, or those that will bring about enhanced values to investors' shareholding. Subsequently it will enable company to continue to operate as a going concern and becoming sustainable. Bolder firms are willing to assume more risks and if fortunate will be rewarded with substantial amount of compensation, as a form of return on investment. Past research has shown that there is evidence of positive association between risks and returns (Ganzach, 2000; Hurdle, 1974). Consistent with an economic theory of high risk high return and a reciprocal low risk low return, it gives an assumption that firms which take higher risk have the probability to improve performance (Klammer, 1973). In the real world, firms which are willing to assume higher risk may be compensated with higher return (Henkel, 2000). The firms are nevertheless aware of the fact that under normal circumstance not all risks takers are handsomely rewarded. On other occasion, the opposite may also happen as the output of business activity may produce negative outcome. This was revealed in a study by Treacy, (1980) that there is also evidence of negative relationship between risk and compensation. Risk taking is not necessarily always rewarded with high return on investment.

When owners register a company, the company is expected to stay as a going concern and sustainable. However there are some firms which will survive and grow to become big conglomerate while there are those which will never make it. Competition among companies is stiff and risks which persist in many forms, and heterogenity in many business aspects are high. Certainly companies believe that for them to survive and prosper, companies would have to take risk. What form of risk and to what extent the risk can be taken is not easy to execute. While company grows and competes at almost even playing field, incorporating risk and goverance has been vital for the firm's survival. Therefore an issue of corporate governance is important as it will guide companies in overseeing and managing risk. In order to accomodate the need to oversee risk efficiently, mainly at the strategic and board level, independent directors are engaged as part of fulfilling corporate governance responsibility and as an oversight board. The research will investigate to what extent risk and governance would become an important part of organizational management. It will seek to explore further the common traits of corporate governance compliance and the extension of risk element, undertaken by companies that have succeeded (MSWG, 2011) and what are the characterist of risk and corporate governance of continuously unprofitable companies (classifed as companies which have failed under PN17 in Bursa Malaysia and thereby suspended from listing). An equation which embeb the research construct is expected to develop an index of risk and governance for companies listed at the Bursa Malaysia.

Managing and assessing risk and corporate governance have remained relevant for many practitioners as well as academicians. While company grows and competes rigorously in order to remain sustainable and viable, accepting and incorporating risk and goverance have been vital for the firm's continued existence. In other words, firm will continue to pursue business sustainability in order to exist as a going concern. Given the above, this research is expected develop an index of risk and governance for companies listed at the Bursa Malaysia. Risk is expected to be examined pertinent to operational risk, financial risk and strategic risk. A construct that represents each risk will be identified of which a ratio will be extracted to be developed into an index. From an estimated 1000 companies listed at Bursa Malaysia from 2001 to 2014 the number of firms has been reduced to around 390 companies. A static panel regression will be expected to be run on risk, corporate governance and as a going concern construct, to find characteristic of companies, first on successful companies, second on on trouble companies, and finally on average form of companies. The reduction in the number of companies has been due to a substantial amount of data that has insufficient information which may lead to severe unbalanced data when panel regression is to be undertaken.The research output is expected to come up with an index on risk and governance from those companies which are considered to be profitable for the last 10 years of operation. It will provide a general guideline or overview on what level of risk the company can adopt if it has to be sustainable as a going concern company.

Over the years we have observed waves of financial crisis affecting companies across the globe. The impact of financial meltdown no longer hovers over one country alone. Businesses which are transacted and traded across countries are becoming more globalized and open. When there is financial turmoil, many firms in those countries with weak financial structure will certainly be severely affected. Firms with stronger governance compliance and have taken appropriate actions to mitigate risk, are therefore more likely to survive and becoming more sustainable. The global financial crisis in 2007 saw the downfall of business empires in the United States, causing blistering shock to worldwide financial system. There were reports of the collapsing of big conglomerates such as Bear Sterns, Fannie and Freddie Mac, melting down of Lehman brothers and the disposal of Merrill Lynch. All these have brought about financial instability to world financial market. Growth of big business corporations in the United States were brought to a standstill. Many went into bankruptcy due to excessive risk taken by companies and individuals during the subprime period before the crisis, where firms did not take serious notice of having good corporate governance and practicing careful and mitigated risk at the work place. This financial turbulence was later translated into financial woes in the Asian region and Malaysia in particular was not spared.

2. PROBLEM STATEMENT

Given the competitive nature of the current business environment, managing of companies have to take a more inclusive and holistic approach. Building on a foundation of using the most up to date technology and having hardworking employees at the workplace, are no longer sufficient to support the business organization, if it is to continue to be viable and to position itself as a going concern organization. To remain relevant, the company has to take risk in order to benefit from higher returns. Managing risk is about dealing with uncertainty in the production of any unexpected outcome. As part of corporate activities, taking and managing risk effectively is vital. Members of the board or the corporate top management are expected to manage risk rather than ignoring them, and their involvement is even more critical during turbulent economic climate. Therefore, there is a need to call for greater responsibility pertinent to risk management among companies.

Not all companies are badly affected during financial crisis. There were companies which have withstood financial meltdown, while there are others which have failed miserably. Those companies that had persevered and remained viable during financial difficulties are those whose financial foundation on managing risk and corporate governance are strong. Certainly, there is a greater need to study the level of risk that those companies have undertaken both at the strategic and operational level. The other part is to interlink degree of risk taken by the company with the corporate governance structure that has been instituted at the work place. Measuring the level of operating and strategic risk from the perspective of the corporate governance is indeed a challenging area for research and will continue to spark a research gap in the field of corporate governance and risk. Operating risk may be reflected by the level of overall operating cash generated from operation. Well managed operating risk would assist in cutting uncertainty that will bring about quality improvement and cost reduction. In this way it would help to contribute to achieve company's goal, creates competitive advantage and improves business efficiency (Claus and Daniel, 2012). Business trade is supposed to define business purpose and not only will it be required to generate revenue and profit but also to precipitate positive cash flow. Strategic decision cannot discount the risk factor from a failed business venture, low profit, slow sales or non-quality product. Firms may incur capital expenditure for the purpose of expansion, maintaining sustainability and steering growth, which are all parts of firm strategic action which may involve strategic risk (Allan & Beer, 2006). Amount committed on capital expenditure and new investment from major strategic decision would all require board approval. A plausible financial risk may surface from too much borrowing. In dealing with all these challenges, there may be a need for a monitoring party to provide signal to the company, that the companies are over exposed to financial borrowing and the organization has failed to raise internal and equity financing. Monitoring of the critical evaluation before commitment can be done need to be carried out. The issue is, to what extent the independent directors being asked to perform corporate governance monitoring and policing. This presents a new gap in this research. Are the independent directors being given complete authority to oversee strategic decision of the board? The research is indeed motivated to look for financial platform which would steer the companies towards achieving sustainable financial structure that would allow them to operate as a going concern. Independent directors in the nomination and audit committee could play the oversight role with at least to provide a signal to the organization that it is heading for a difficult time from organizational strategic and operating activities. This research will identify the level of risk by providing indexing to different class of risk while looking at the ratio of independent directors that are engaged by the organization. The study which will hypothesize that organizations are risk-sensitive and that independent directors can play the role of risk oversight players could orientate the company towards sustaining itself as a going concern.

In the context of the above, the main objective is to construct a performance index from adoption of heterogeneous risk and governance structure of successful Malaysian Listed Companies.

Given the above issues, the main objective of the research is to construct performance index from the adoption of heterogeneous risk and governance structure of Malaysian Listed Companies.

This study embarks on the following objectives:

a. To evaluate if the companies whose index score on risk structure would sustain organization as a going concern;
b. To determine companies with high index score on both risk and governance would facilitate companies to operate as a going concern; and,
c. To develop a final performance indexing on risk and governance structure clustering companies into successful companies with high index, average companies with medium index and finally unprofitable companies with supposedly low index.

3. LITERATURE REVIEW

In an emerging business environment, it is important for firms to manage its risk in dealing with uncertainty in business activities. Managing risk depends on management attitude towards risk. Company which incorporates good governance will take a reasonable risk in order, not to over expose itself to risk putting the company in jeopardy if the negative outcomes do happen. Good governance propagates effective risk management which can potentially provide perseverance to withhold adverse events and also the ability to take advantage of the firm’s opportunities to improve and sustain organization performance as a going concern, not only in the short run, but also in the long run (Parvez, 2013). In an effort to increase revenue, firms may take aggressive initiative in its strategic decision such as embarking on high capital commitment. With the right governance among the top management, the capital expenditure commitment and the output in revenue and profit may be expected to move in the same direction or positively related, as in the case of study done by Callen, Livnat & Ryan (1996), Lev and Thiagaranjan (1993). Capital expenditure is a form of financial commitment that the firms undertake through strategic decision (Jiang, Chen and Huang, 2006). Risk modeling such as Enterprise Risk Management (ERP) motivates this research, as it incorporates holistic, integrated and process-oriented approach in managing business risk (Stephanie, 2009; Gordon, Loeb & Tseng, 2009) ERM enable opportunities to assess capital requirement more effectively to improve capital allocation (COSO, 2004). Other risk such as operational risk and financial risk due to over exposure from high leverage requires severe attention. Firm should have a reasonable amount of working capital capability for it to function effectively (Padachi, 2006; Qasim and Ramiz, 2011). Financial risk is the form of risk inherited by the company depending on the nature of funding which could either by debt or equity or both or predominantly dominated by one form of financing. Some firms are all equity financing while others have low equity financing but with higher debt. Previous research found that firms with lower debt has better chance of maximizing its value (Ngobo and Capiez, 2004; Goddard, Tavakoli & Wilson, 2005; Maury, 2006; Zeitun and Tian 2007; Nunes, Serrasqueiro & Sequeira, 2009).

4. RESEARCH METHODOLOGY

The data analysis will be based on extraction of data from a set of about 390 companies which has been trimmed from over 1000 companies listed at Bursa Malaysia consisting of all the sectors, for period from 2001 to 2014.

The design of the research will involve few stages.

The first stage will explore the viability of the firms by maximising utilization of independent directors in the common ID committee that has been adopted for the last 12 years (Tinggi, Md Isa, Jakpar, Sabrina & Sehari, 2014). It involves identifying the three categories of company, which will be ranked by level of profitability. The class of company identified will be categorized into non-profitable, next will be having Return on Assets (ROA) between 0 – 10 %, followed by >11% Return on assets. This finding will be compared against those companies falling under PN17, 31 successful companies reported by Minority Shareholder Watchdog Group (MSWG,2012) and the balance is the average companies to identify for similarity.

A controlled variable is also developed which will look at the successful companies (31 firms from MSWG, 2012) & unprofitable companies (PN17 firms, Bursa Malaysia 2014) and finally the average companies with average return.
Next is the second stage, which is incorporating both corporate governance and risk issues.

The companies will be examined on the level of operational (liquidity and working capital), financial (debt exposure) and strategic risk (capital commitment) and an index will be identified based on the percentage of the amount earned, secured and committed of the overall related financial structure. For example, as for capital expenditure, if the amount committed represents 10% of the combined operating, financing and investing activities, the index given will be 1 and if it represents 50% a 5-point index will be given. The level of independent directors' involvement will be measured with regards to its component at the board members, at the nomination and audit committee but excluding the remuneration committee. The nomination and audit committee are selected because it involves independent directors' role in strategic and risk management, even though it may not be clearly spelt out. For each of the different class of company, an observation will be made to correlate its index value with its ROA. The company with a relatively high and constant value of ROA is expected to be associated with a company which is assumed to be able to sustain as a going concern.

The index score that has been developed will be run using the panel regression to test for sustainability as a going concern, *Susit* is a function of $\alpha + \beta 1 Bdit + \beta 2Noit + \beta 3Auit + \beta 4OPit + \beta 5FRit + \beta 6Strit + \lambda i + u\, it$ (Arellano & Bond, 1991; Arellano & Bover, 1995). The panel regression is more robust and efficient. *Susit* represents the firm return on assets (*ROA) for sustainable as a going concern; Bdit as the number or percentage of independent directors(ID) in the board; Noit* as the *number or percentage of ID in the nomination committee; Auit as the number or percentage of ID in the audit committee; OPit as the Net operating cash flow for operational risk; Frit as the Debt ratio for financial risk; Strit as the Capital expenditure ratio for strategic risk*, and finally εi *is the Error term.*

Certainly the panel regression will go through a process of running through the Constant co-efficient Model(OLS), Random Effect (RE) and Fixed Effect (FE) Model in order to determine the appropriate model to be adopted.

In the process, selection between the Constant Coefficient Model will have to run through the Breusch and Pagan Lagrangian Multiplier (LM) test, $\frac{NT}{2\,(T-1)}\left[\frac{\sum_{i=1}^{N}\left(\sum_{t=1}^{T}\hat{\Sigma}\, it\right)^2}{\sum_{i=1}^{N}\sum_{t=1}^{T}\hat{\Sigma}^2 it}-1\right]$, while the selection between the RE and FE model will have to run the Hausman test, $(\hat{\beta}_{fe}-\hat{\beta}_{re})^1\,(\hat{\beta}_{fe}(-\hat{\beta}_{re})^{-1}\,(\hat{\beta}_{fe}-\hat{\beta}_{re})$

A test for structural stability (RAMSET), heterocedasticity, serial correlation and multi-collinearity will also be conducted to ensure validity of the reliability of the model that is going to be adopted. The structure of the index from the above analysis will be analyzed after getting evidence from the panel data regression. The index will be finally drafted for the three different classes of companies with regards to the company's perception to risk and corporate governance. A cumulative Index score formulated for both successful and failed companies, where the index score for successful companies will be compared against the failed and other normal companies. A cumulative average weighted score will be finally computed to reflect both successful and failed companies from corporate governance and risk perspective.

However the proposed data that requires panel regression will be further re-examined. The estimation model may be broken down into sub-sample which will be assumed to have more estimation power than the panel regression. Otherwise, an alternative is to cluster the year of the estimation model, that may assumes no individual and time series effect, resuting in a risk of falling into fixed effect model in a Hausman test (Hausman and Taylor, 1981; Baltagi, Song & Koh, 2003; and, Kao (1999).

Developing an index index has its own theoretical procedure (Morrison, 2014; Yong and Wenhao, 2012). In selecting the predictor variables for estimation model, it is ecouraged that a principal component analysis or discriminant analysis may be run, and subsequently breaking it further down to run either using the forward-wise or backward-wise model. In the regression estimation model, PN 17 may be treated as dummy variables or at least quantile the highest heterogenous risk firms. Finally the panel logistic regression may be run, while a check for robustness for checking the maximum likelihood estimation(MLE) may be conducted.

5. CONCLUSION

Developing a model that incorporates element of risk and governance over the traditional method of using profit alone to measure firm performance has been an area that has been debated over and over again. The issue of governance has taken a major role as it was realised that governance cannot be ignored. Different form of risks have surfaced and this study focuses on what the author thinks as some of the major risks that the firms are commonly dealing with. The study involve companies from all sectors but has decided that the study will look and compare companies wich are suucessful over those that have not done so well. The result of the research is expected to develop a performance index that would characterize companies that are successful, average and those that are not profitable or considered to be categorised under PN17.

6. EXPECTED RESULTS AND POTENTIAL BENEFITS TO INVESTORS

A performance index on corporate governance and risk that is developed will be used as an alternative form of guideline for companies towards achieving sustainability in order to remain viable as a going concern. This will be a new knowledge in the domain of corporate governance and risk management especially for companies which have incorporated enterprise risk management in the orgaization. Those risk takers could at least be given some cushion for any threat that may impact their investment decision making.

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