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EXPLORING THE PERSPECTIVES OF CORPORATE GOVERNANCE AND THEORIES ON SUSTAINABILITY RISK MANAGEMENT (SRM)

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ABSTRACT

The motivation of this paper stems from the importance of observing good corporate governance by means of SRM approach to create sustainable value for corporate survival. This study explores the perspectives of corporate governance and underlying theories related to sustainability risk management (SRM). There is a growing concern that good corporate governance has an impact on SRM program. Good corporate governance influences companies to adopt sustainable business practices through a more holistic risk management approach in addressing both financial and non-financial risks. Modern portfolio, stakeholder and legitimacy theories are the accepted paradigm in fostering a good corporate governance through the adoption of sustainable risk management in addressing sustainability risk. This paper adds to the literature by highlighting the importance of corporate governance through adoption of sustainable risk management practices in maximizing economic, environmental and social performance.

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Keywords: Sustainability risk management, Corporate governance, Corporate survival, Modern portfolio theory, Stakeholder theory, Legitimacy theory.

Contribution/ Originality

The paper's primary contribution is finding that sustainable risk management is a central aspect of good corporate governance. Good corporate governance would ensure company to act accordance to the best practices through a balance of economic, environmental and social elements.

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1. INTRODUCTION

Sustainability risk management (SRM) has becoming an important tool in addressing the multifaceted risk arising from sustainability issues. There was an increasing attention given towards non-financial and emerging risks by companies due to the crises that took place in these past few years, such as the tsunami disaster in Japan and financial downturn in 2008-2012. SRM is fast becoming an important risk management approach for companies to sustain themselves over the long-term. SRM is an extended enterprise risk management (ERM) approach which manages a broad spectrum of emerging risks and non-quantifiable risks arising from sustainability issues for corporate survival. SRM aims in response to both the unforeseen external events that might bring about high impact risks to the company.

Very often, those risks arising from sustainability issues puts the company survival at risk. In light of this issue, companies must have a greater understanding on the kind of risks that might affect corporate survival by integrating ERM and sustainability (Pricewaterhousecoopers, 2013; World Business Council for Sustainable Development, 2013). Furthermore, Malaysian Code of Corporate Governance (MCCG) 2012 ultimately put greatest concern for every company to promote good corporate governance by integrating sustainability practices into their business strategies.

There was a little importance given by company in fostering good corporate governance through adoption of sustainable business practices in mitigating sustainability risks nowadays (Lenssen *et al.*, 2014). Therefore, this study aims to examine the importance of good corporate governance through SRM approach in addition to exploring the underlying theories related to SRM approach.

2. SRM APPROACH FROM THE CORPORATE GOVERNANCE PERSPECTIVES

Prominent corporate scandals and environmental catastrophes such as the cases of Enron, Exxon Valdez and BP Deepwater Horizon oil spill that collapsed due to poor corporate governance revealed that the major contributing factor to the collapse of these corporate organizations is the greediness to maximize short-term return, as well as ethical violations that had caused value destruction (Laszlo, 2008; Davies, 2012). Corporate governance becomes an important element that needs to be scrutinized by the management since most corporate scandals and environmental catastrophes had resulted from poor application of corporate governance mechanisms. Malaysia's High Level Finance Committee on Corporate Governance (HLFC) (2000) 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 realizing long-term shareholder values, whilst taking into account the interests of other stakeholders*". In other words, corporate governance plays an important role in achieving the company's goals and building a strong relationship with the stakeholders.

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Seeing that corporate governance has a close relationship between stakeholders in the companies, the vital aspect of corporate governance has widened to encompass a broader group of stakeholders in both the financial and non-financial aspects of company's decision-making (Klettner *et al.*, 2014). According to some studies, stakeholders support a degree of influence over defining the company's actions and the deeply held beliefs that companies have greater responsibilities to the society (Schneper and Guillén, 2004; Chen *et al.*, 2009). Every action undertaken by the company, together with the associated risks arising from environmental and social issues are constantly observed by stakeholders (Knox and Maklan, 2004). Stakeholders place their faith on the company to conduct businesses in accordance with the best practices to retain a better corporate reputation (Soleimani *et al.*, 2014). Most of the corporate governance codes emphasized on the stakeholder governance, particularly those that are closely related to social and environmental obligations (Wieland, 2005). Likewise, the Malaysian Corporate Governance Codes 2012 (Securities Commission, 2012) seeks to emphasize the principle of good corporate governance by amplifying the rapport of trust between stakeholders and companies.

A dominant stakeholder group has a significant role in determining corporate goal as required by society (Fiss and Zajac, 2004; Schneper and Guillén, 2004). Apparently, corporate reputation is recognized contrarily to the stakeholder's position as various stakeholder have different expectations (Rubčić and Omazić, 2013). By drawing on the link between stakeholder governance and corporate reputation, Soleimani *et al.* (2014) found that a positive impact of stock price performance on corporate reputation is ultimately dependent on the stakeholder power, provided that the company meets the stakeholder's expectation. Accordingly, Marchetti (2011, p.158) ascertained that "*good corporate governance translates to better reputation, which may positively affect stock price or company value. Finally, robust risk management and internal controls lead to better operating performance for the organization*".

Corporate governance and risk management are interrelated as both emphasize on the coordinating strategy to meet corporate goals. Good corporate governance is a basis of prudent risk management. This is supported by Power (2003, p.150) who has indicated that "….. *risk and the organizational imperative to manage it appear, at least on the surface, to be able to internalize external interests and align them with corporate imperatives in a way that was previously impossible. Risk is the basis for corporations to process morality*". Adhering to good corporate governance, perhaps intensifies the company's potential to create sustainable value while managing risks through achievement of corporate goals (Aziz, 2013; Tricker, 2015).

Good corporate governance is important in achieving sustainable value through a balance of the economic, environmental and social aspects (Aras and Crowther, 2008). In this light, SRM approach entails good corporate governance practices to help companies to sustain themselves in the long-term. Good corporate governance and sound risk management are the basis of corporate survival (Manab *et al.*, 2010). As argued by Marchetti (2011) the establishment of the tone at the top signifies a good governance in which the board together with the management play a significant role in overseeing risk management to elucidate and monitor company's strategy, in

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addition to reduce the impact of risk. Here, it is important to stress the significant role of the board in corporate governance and risk management practices. This view is supported by De Lacy (2005, p.17) who has elucidated that "*the whole area of contemporary corporate governance swings on the complexity of the risk and the understanding of the risk by the board*". Notably, SRM approach emphasizes on company's ability to do well and sustain through the practice of good corporate governance in coping with the complex risk landscape for corporate survival.

3. THEORETICAL PERSPECTIVE OF SRM APPROACH

3.1. Modern Portfolio Theory

Modern portfolio theory (MPT) stresses the idea that risk can be known as both perils and opportunities in which the business goals mainly aims to not avoid or lessen risks, but to look for an optimal return at an acceptable or desirable level of risk (Boatright, 2011). For the most part, MPT emphasizes that management is responsible in selecting investment projects at the efficient frontier which generates higher return to the company. Systematic risks and idiosyncratic risks are two major components of the underlying risks in MPT. Systematic risks are uncontrollable whereas the idiosyncratic risks can be controlled by the company. Based on the assumptions in MPT, the company would be able to eliminate the idiosyncratic risk through a portfolio diversification (Markowitz, 1952; Sharpe, 1964). Most of the investors intended to generate higher return by holding a group of assets for minimizing the risks (D'Antonio *et al.*, 1997). Portfolio diversification in MPT theory would be able to reduce unsystematic risk; however the systematic risk is not affected (Lubatkin and Chatterjee, 1994).

There is a strong evidence that ERM embraces MPT theory as ERM incorporates all types of risks in a portfolio and all risks are correlated (Nocco and Stulz, 2006; Beasley and Frigo, 2007; Rochette, 2009). Since SRM is an extension to ERM approach, this study recognized the connection between ERM and MPT. According to Miccolis (2003, p.2) "*the science and practice of ERM is rooted in MPT...the essence of ERM is very much the exploitation of the 'portfolio effect' described by MPT*". It is also argued by Beasley *et al.* (2008) that ERM embraces the concept of MPT.

SRM brings together into focus the financial and non-financial dimension of risks. Rational investors often concentrated on the sustainability indicators to observe the social, environmental and reputational risks in their portfolios. Ultimately, the degree of environmental, social and governance (ESG) risks vary accordingly to the types of industry and region in which the company operated (CFA Institute, 2008). Several studies were done in identifying the relationship between the ESG risks and economic performance. Goyen *et al.* (2005) indicated that 'rational investors' often consider the sustainability criteria in selecting investment portfolio to reap advantages from the sustainability opportunities. Aupperle (1984) found a positive correlation between economic and social dimensions with the company's total risks. Meanwhile, McGuire *et al.* (1988) found that the relationship between risks and social performance are inversely related. Referring to MPT, those investors who integrate social funds together with other securities in their portfolios would

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find lower correlation which contributes to greater risk-return selections. The amount of risks can be reduced much when the correlations of return between securities is lower (Hickman *et al.*, 1999).

In contrast, Lydenberg (2007) found that most investors are not keen to have a look on an optimal return that bring value to the society and environment entirely. In addition, Vyvyan *et al.* (2007) also discovered that financial performance was still desired by investors in investment decision making since there was a insignificant relationship between environmental and societal value with investor value. Amran and Zakaria (2007) identified that Malaysian companies usually emphasize on the financial aspects in investment decision-making rather than environmental and societal aspects.

3.2. Stakeholder Theory

Stakeholder theory is an underpinning theory that supports the ethical business conducts by the company (Carroll, 1998). Stakeholder theory suggests that social responsibility initiatives undertaken by the company portray the company's significant relationship with the stakeholders which improves business performance since the integration of economic, environmental and social elements create value for the stakeholders (Luis *et al.*, 2012). Stakeholder refers to "*individuals and constituencies that contribute, either voluntarily or involuntarily, to its wealth-creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers*" (Post *et al.*, 2002). Besides, Desjardins (2009) argued that "*stakeholder theory shows that each business decisions influences a wide range of people by bringing revenue to some and expenses to others*". In other words, stakeholder theory stressed on business approach that takes into account the ethical responsibilities towards stakeholders.

The interest of stakeholders must be pursued predominantly by the company. Therefore, the element of social responsibility should be adhered in meeting the stakeholder needs (Chilosi and Damiani, 2007). According to Clarkson (1995), company's survival relies on the capabilities of the company to create value to the stakeholders. Jensen (2002) argued that the maximization of long-term market value cannot be achieved if the company ignores the stakeholder's needs. He further clarified that "*enlightened value maximization utilizes much of the structure of stakeholder theory but accepts maximization of the long-run value of the firm as the criterion for making the requisite tradeoffs among its stakeholders and specifies long-term value maximization seeking as the firm's objectives*" (p.235). In other words, a company would be able to maintain its ability to operate by contributing a greater value to the stakeholder which in turn would maximize its long-term financial value. A company that is able to protect the interest of the stakeholders can ultimately keep support from the stakeholders as maintaining a good relationship between the company and stakeholders is critically significant to corporate survival (Arevalo *et al.*, 2011; Kiron *et al.*, 2012). The stakeholder theory also ascertains that the strength of this relationship helps the company to sustain in the long-term (Rahardjo *et al.*, 2013).

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Stakeholder theory covers three importance aspects of economic, social, and environmental value creation (Wheeler *et al.*, 2003). Stakeholder theory is pertinent to the concepts of sustainability, CSR and corporate governance (Zambon and Del Bello, 2005). In relation to CSR concept, it is closely related to stakeholder theory since it involves the stakeholder engagement in addressing social and environmental issues (Pedersen, 2006). The stakeholder engagement bring benefits especially in reducing risks associated with the company such as financial, reputational and political risks (International Finance Corporation, 2009).

The application of stakeholder theory also has been used in the field of risk management, specifically in ERM practices. In a similar vein, Beasley *et al.* (2006, p.49) indicated that, "*ERM seeks to strategically consider the interactive effects of various risk events with the goal of balancing an enterprise's entire portfolio of risks to be within the stakeholder's appetite or tolerance for risk*". The stakeholder interest is significant in assessing those risks which affect company the most. Thus, this would help company to manage risks associated with the environmental and social elements efficiently. On the other hand, a study done by Lim and Wang (2007) also employed the stakeholder-based view in managing risks whereby it was found that the company's systematic risks can be reduced through financial hedging and this in turn can increase the investment by stakeholders.

3.3. Legitimacy Theory

An important factor acknowledged to be influencing companies in adopting SRM practices is the drive to achieve legitimacy in reducing their risks to social and environmental pressures. Legitimacy theory stressed that legitimacy is a crucial aspect for companies for building strong relationship with stakeholders by having ability to operate within a manner to avoid putting corporate survival at risk (Gray *et al.*, 1995). For Suchman (1995) legitimacy refers to ''*a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions*''. The notion of legitimacy heavily relies on a steadiness of managerial actions to meet the stakeholder's expectation (Mathews, 1993). Generally, both legitimacy and stakeholder theories hold identical characteristic on building rapport between company and specific groups in a society (Richardson *et al.*, 2013).

Notably, companies need to fulfill their obligation towards society and environment instead of focusing on financial benefits only. Buhr (1998) demonstrated that companies attempt to "*achieve legitimacy by appearing to do the 'right things' or not be involved in doing the 'wrong things' when this appearance may have little in common with a company's actual*" performance. The failure of company to meet the legitimacy resulting company would only gain short-term profit. Besides, company's survival is at risk due to company failed to meet the stakeholder's expectation (Deegan *et al.*, 2002). Beyond this theoretical discussion, it can be observed that modern portfolio, stakeholder and legitimacy theories are relevant in explaining the outcomes of SRM approach. SRM approach is a paradigmatic shift for companies through a forward-looking view in adapting a

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complex risk landscape as well as meeting the stakeholder expectation in attaining better economic, social and environmental values. Companies should now prepare to adopt SRM approach in meeting the needs of future generations through a balance of economic, environmental and social elements.

4. CONCLUSION

This paper provides a significant theoretical and practical importance of adopting good corporate governance through sustainable business practices within the framework of SRM. Good corporate governance is critically importance in achieving sustainable value and building a strong relationship with stakeholders for corporate survival. Modern portfolio, stakeholder and legitimacy theories are applicable in explaining the significance of SRM approach for a company in encountering sustainability issues to reduce sustainability related risks.

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