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Overview of ESG Practices in Malaysia with Introduction of Conceptual Framework

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Abstract

Owing to weak awareness of sustainability concept and insufficient research in developing countries like Malaysia, as well as recent incidents from corporate dilemma, this study aims to analyse and propose a more appropriate conceptual model to depict the workable relationship between variables. This paper contributes to the literature by designing a conceptual model for Malaysia' environment, social and governance (ESG) disclosure on listed firm financial performance by proposing return on asset (ROA) and return on investment (ROI) as financial profitability objectives. This study also identifies four different contracts as moderating variables to inspire more transparent disclosure pertinent to ESG. To provide an insight into the proposed ESG model, the article also discusses multiple theories and further emphasized the implementation of ESG has actually further satisfied the various expectation from different parties involved as concern with legitimated motive as ultimate guardian. ESG disclosure has also encouraged more transparency, pertinent and timely disclosure to mitigate information gap.

Keywords: ESG Disclosure, Sustainability, Financial Performance, ESG Performance

Introduction

Financial concern whether firms are able to achieve financial objectives like profitability, favourable return on investment and high performing share price, a growing concern from investors are pursuing on the flip side of firm performance which is non-financial performance as one of the core business objectives. For strategic decision making, financial and nonfinancial information are interplay for every concrete decision. ESG is just one of the popular sustainability measurement tools which has been developed voluntary by globally rating agencies like Bloomberg, to assess firms' non-financial performance with the consideration of risk and opportunities matrix surrounding the companies. Therefore, the demand call from shareholders have been doubled in the last two decades (Grewal et al., 2016).

Companies persistently pursuing short term profit by neglecting sustainability issues such as environmental and societal issues will be deprived from market competitive opportunities in the long term and bring forward damage to the management and corporation, including affected stakeholders and shareholders. For instance, the company is employing conventional type of capital assets to run its operation which are creating severe pollution to the environment, even though it may seem it is very cost efficiency by running the process in such way at this moment, it may even try to control its running cost by providing accommodation which are unfit for its operational staff result subsequent infection being spread rampantly. All these factors will be reflected and shown in their sustainability performance report by their voluntary disclosures or subsequently exposed by the media which eventually will affect their ESG scoring in the market. ESG screening is, as a result, another avenue to access companies' sustainability performance through mass media, annual report, sustainability reporting and other publicly available sources (Mcintosh, 2016).

It is believed the awareness of sustainability like ESG arisen from a series of major events happened in the history due to severe environment pollution like oil spill caused wild life endanger in Santa Barbara, California, unequal treatment to the Black, workers and women due to racist and gender inequality, group against Vietnam war to cry for world peace. All these incidents have resulted ESG first time in the history being coined in a landmark study entitled "Who Care Wins" conference in 2005 convened in Zurich, an important milestone that have gathered all the important and influential positions like governors, financial advisers, bankers, investors from different nations, to discuss, share various perspectives to develop concrete tools, align strategies and services to solve world crisis (Zurich, 2005).

According to Bursa Malaysia, ESG has become a key consideration for investors and the country has attracted 236 ESG mandated funds globally which has invested in Bursa Malaysia with a total holding value of USD 143.5 billion as at Feb 2022 (Bursa Malaysia, 2022). Besides this, during 2019, a total capital of investing fund of US$ 17 billion has flowed into ESG related investment products, which is almost 525 percent increase since 2015. It is partly attributed by global COVID-19 pandemic which has diverted attention from investors to focus more on sustainability agenda such as environmental preservation, zero emission target, promote fair treatment, deforestation and others (Morgan, 2020).

In order to resolve pressing and critical sustainability issues over the next 15 years, all 193 United Nations members states across the world including Malaysia, have adopted "Agenda 2030" in September 2015, which comprised of 17 goals and 169 targets under Sustainable Development Goals (SDGs). Malaysia has actually addressed a number of SDG targets through the integration of 11th Malaysia Plan for its first phase implementation (2016-2020) (Bursa Malaysia, 2018). Malaysia has also included in its 12th Malaysia Plan to address and eradicate poverty issues in the country (Musa, 2021). Furthermore, Bursa Malaysia has even collaborated with FTSE Russell from UK to launch FTSE4Good Bursa Malaysia index in 2014, with the intention to encourage and motivate more corporation to adopt sustainability practices by recognising those public listed firms who have make an endeavour to achieve overall satisfactory level of sustainability activities and reporting. This index will assist foreign investors to make wiser decision by helping them easily identify those firms who have achieved sustainability performance by screening their ESG scoring.

Literature Review

According to PricewaterhouseCoopers (PWC), ESG has become very common and popular and has been one of the most common acronyms widely used around the globe in all kinds of situation from climate change, anti-corruption, anti-poverty to reform justice, especially over the past few years. There will be increasing ESG disclosure expected from listed firms, and regulators are increasingly moving towards codifying ESG performance. Nevertheless, investors generally still prefer companies which they are investing are meeting shareholders' expectation by meeting targeted financial performance, and at the same time, the companies are able to convince the investors that they have considered and responded risk and opportunities pertaining to ESG practices. It is even critical for companies who are about to go for listing (Picard & Newman, 2022). Therefore, companies may be deprived from foreign investment fund and even face challenges for retaining or attracting right talent if they choose to be ignorant to market expectation to their sustainability practice and relevant disclosure. Besides this, to select an appropriate reporting framework is also considered critical and Integrated Reporting is one of the recognised frameworks to report ESG disclosure (Pavlopoulos et al., 2019).

It is essential for reporting firms to exercise sensible judgement on the level of ESG disclosure. Whether it is ESG strength or ESG weaknesses, over reporting or under disclosure may harm the future of the company, the firm must therefore maintain a balance over ESG disclosure owing to different perceptions from various users (Sadiq, 2020). It is even peculiar and prominent for ESG achievers than losers, because of the selected screening method which institutional investors typically view through the best-in-class positive screening (Shanaev & Ghimire, 2021). For ESG disclosure in Malaysia, it is also perceived negatively especially come to ESG strengths, the stakeholders may think the firms are trying to justify the higher level of expenditure spent on ESG related activities (Sadiq, 2020). Nevertheless, it is discovered that over disclosure of ESG may benefit those firms who are experiencing negative impact caused by ESG concern (Fatemi et al., 2018). Some firms may even grab the opportunities to reduce fines and penalties from the prosecutors by coinciding with the official antitrust investigations by initial new CSR effort (Ferrés & Marcet, 2021).

Not all markets are supportive and responsive to firms who are engaging in socially responsible activities. By using Italy as an example, the stock exchange market in the country does not seem to reward those listed firms who are practising CSR due to the abnormal stock returns are not substantial by ESG rating (Landi & Sciarelli, 2019). Similar study on 46 firms listed on Surostoxx50 also experienced the same phenomenon, their efforts of ESG commitments are not reflected and shown in their market performance (Torre et al., 2020). On the contrary, when we look into data provided by Refinitive covering 60 countries from 2007 to 2017, which has provided us different inspiration and insight. Those countries are excellent in their ESG performance have reaped the rewards by experiencing lower credit default swap, flatter credit default swap credit curves (Hübel, 2020). Even in China, the market also discovered ESG performance is strengthened during crisis and as lessened in normal time (Díaz et al., 2021).

Even though firms may have diligently reported ESG disclosures in their reports and company websites, there are still challenges and hindrances faced by the various ESG users as stakeholders when come to application of their ESG data, even if their data may be supplied by different rating agencies. Problems like data inconsistency, different standard of benchmarking, various method of data computation, all these are the factors attributing to the data comparison difficulties and challenges (Hübel, 2020).

According to Cadbury Report published in 1992, it is discovered majority of independent directors are deficient in knowledge in management due to their appointment could be due to political consideration. For Malaysia, most of the listed firms are run by family members resulting larger shareholding. Family firms are generally lack of awareness of corporate governance practice and requirement (Jakpar et al., 2019). Gentle or racial diversity in boardroom is encouraged with sufficient rules and regulations to evaluate firms' performance especially closely help entities (William Rees and Tatiana Rodionova, 2015). Malaysia has therefore, promoted gender diversity by recommending 30% women directors on boards in its latest Malaysia Code on Corporate Governance (MCCG) 2021. To align with the United Nations (UN) recommendation and requirement to report, announce and realise ESG practice by year 2030, Malaysia has recommended listed firms to fully disclose their corporate policies and sustainability related activities as part of the company regular reporting across the years of its operation (Masliza et al., 2021).

ESG reporting in developing countries may be ambiguous owing to the reporting requirement is voluntary and recommended (Khoury et al., 2021). It is proven ESG is able to contribute positively to the financial growth as corporate performance in developed countries, but little research has been covered for developing countries such as Turkey, Malaysia and etc result insignificant awareness (Saygili et al., 2021). Though, ESG disclosure companies in Malaysia found to be able to gain market acceptance and deliver better value to shareholders. But the development of ESG disclosure is still young and more studies are recommended to extend larger sample for future study due to Malaysia has no strict regulations on ESG disclosures and reporting (Masliza et al., 2021), secondly, only a small number of big listed firms' disclosure on ESG (Ismail & Latiff, 2019; Modugu, 2020). However, another research finding shows conflicting outcome that larger market capitalization firms tend to invest more than what is required from them even though not all firms are impacted by the new requirement, that means, the mandatory requirement for Malaysian listed firms for more than 2 billion of market capitalisation are only complied to report sustainability as non-financial disclosures (Kee et al., 2020).

Furthermore, Malaysia is recovering from the impact from COVID-19 pandemic, the research finding may be different from other countries. For instances, it is discovered European market has shown some correlation between ESG and market performance during the pandemic (Engelhardt et al., 2021). On the contrary, the Korea market has generally been affected badly by the pandemic, only the difference is for those firms who have achieved higher performance of ESG activities have their earnings declined minorly (Hwang et al., 2021). Malaysia has been rated recently and its result is quite devastating in 2021 of State Department's Trafficking in Persons Report issued by United State due to allegations of human right abuses by local listed firms, Malaysia has therefore been downgraded to Tier 3 from Tier 2 previously (Azhar, 2021). The recent executive including major shareholders have been charged by Securities Commission due to submission of false statement to Bursa Malaysia (Ahmad Naqib Idris, 2021). Owing to a series of corporate incidents, the latest Malaysian Code on Corporate Governance (MCCG) has reemphasised independent role of directors, gender diversity, no dual chairman for more than one committee, recommended appropriate remuneration policy and other new reporting requirements to improve governance structure. Hence, it is imperative to conduct research in Malaysia by proposing different conceptual model to contribute academically, industry wise and local policy makers.

Table 1
Summary of ESG argument from different authors

Authors & Year	Arguments for ESG
(Díaz et al., 2021).	ESG performance is strengthened during crisis.
(Engelhardt et al., 2021)	Some correlation between ESG and market performance during the pandemic.
(Fatemi et al., 2018)	ESG may benefit those firms who are experiencing negative impact caused by ESG concern
(Hübel, 2020)	Data inconsistency, different standard of benchmarking.
(Ismail & Latiff, 2019)	Only a small number of big listed firms' disclosure on ESG.
(Jakpar et al., 2019).	Family firms are generally lack of awareness of corporate governance practice.
(Kee et al., 2020)	Larger market capitalization firms tend to invest more than what is required to report more ESG information.
(Khoury et al., 2021)	ESG reporting in developing countries may be ambiguous.
(Landi & Sciarelli, 2019)	Abnormal stock returns are not substantial by ESG rating.
(Masliza et al., 2021)	No strict regulations on ESG disclosures and reporting.
(Picard & Newman, 2022)	Critical for companies who are about to go for listing
(Saygili et al., 2021)	Little research has been covered for developing countries.

Methodology

The objective of this research is to design a conceptual model for ESG model applicable to the Malaysian market which is quite similar to a conceptual model proposed for a car sharing system catered for a particular country's market (Amirgaliyev et al., 2022). Given the latest revision of the MCCG 2021 and also recent researches highlighted to conduct more studies in developing countries to arise sustainability awareness and to enrich existing knowledge of research field, with couple of incidents related to weaknesses in governance dilemma happened in Malaysia recently such as resignation of several directors due to submission of misleading corporate financial information, which could be sign of weaknesses in stewardship or lack of independent role of directorship results poor decision being delivered. Because of being negligent in handling of societal issues result subsequent goods being withheld in overseas port, respective company's market shares were as a consequence, trembled in the marketplace not to mention loss of revenue.

Apart from introduction as background of the story and some pertinent empirical research briefly shared about some pertinent research findings and insight on ESG from abroad and Malaysia market, we will come out a conceptual model depicting the impact of ESG to firm financial performance with few constructs involved as moderators in the context of corporate world. We will also bring out few theories which will further refine the proper operation of the model.

Results and Discussion

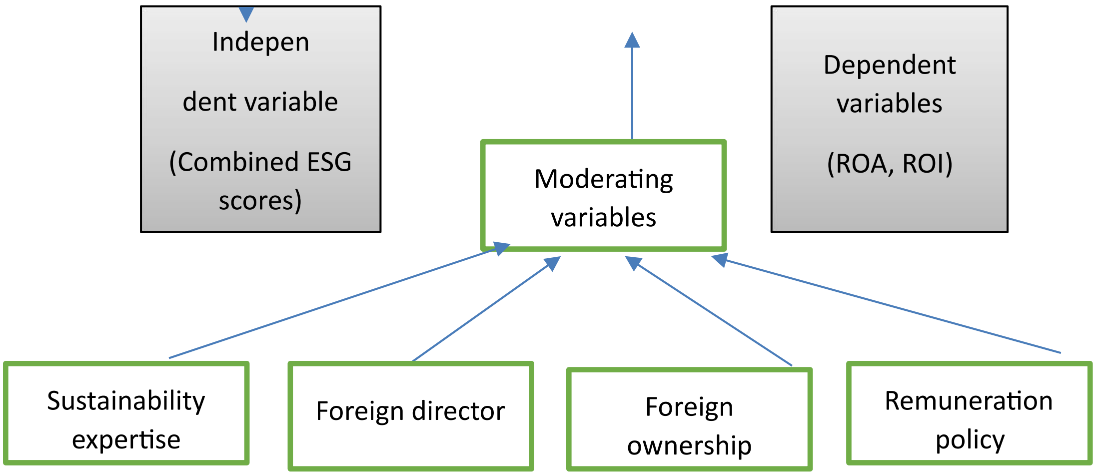

Figure 1 Conceptual Model

Our conception model as shown in figure 1 consists of combined ESG as independent variable, sustainability expertise, foreign director, foreign ownership and board remuneration policy as moderating variables. To measure firm performance as dependent variables, we have included constructs like return on assets (ROA) and return on investment (ROI) as numerical measurement.

Independent Variable
We will have combined ESG score as our independent variable instead of separate Environment, Social and Governance as individual independent variables as suggested by some of the scholars (Díaz et al., 2021). We feel that most of them are interplayed, and it is unjustified to separately access them by individually evaluate their impact to firm performance. For instance, to meet clean water and proper sanitation goal as part of environmental objectives, we need to consider involving directors as part of ownership and directorship to ensure the goal is properly supervised and is on track, which fall under governance. Apart from this, involvement from auditors and risk assessment are critical enough to access whether the result of meeting clean water is valid with supporting documents and other relevant risk has also been considered. By meeting target of clean water and sanitation, we are indirectly meeting the other target of good health and well-being which falls under social component of ESG.

Dependent Variables

ESG disclosure promotes transparency by furnishing pertinent operational and strategic information to stakeholders other than regular financial information, it has therefore enhanced firms' value by assisting investors to make wiser investment decision (Li et al., 2018). Through ESG disclosure, the asymmetric information gap between firms and users of the information can be narrowed and eliminated. One of the common measurements to access the impact of sustainability practises on firm performance is corporate financial performance. In fact, not all findings from the past literature studies witnessed the positive impact of ESG disclosure on firm financial performance including crisis like corporate and financial crisis. By using study about ESG impact on firm performance in East Asian firms, the findings are mixed, and it is due to the market in the region is price sensitive rather than sustainability rooted culture (Khoury et al., 2021). Similar research of ESG about 500 firms S&P in US also produced varied outcome with mixture of positive and negative findings (Aouadi & Marsat, 2018).

Besides Tobin-Q, ROA and return on equity (ROE) are those financial ratios which have been frequently used as financial measurement as health checker of corporate financial performance. On the other hand, other financial instruments have been suggested by scholar to consider for future research in order to enrich the existing studies (Zabri et al., 2016). Consider applying more than one financial ratio to measure firms' profitability was also well recommended (Jakpar et al., 2019). ROI will be proposed as one of the dependent variables other than ROA. ROI is used to measure company's ability to manage its investment fund from shareholders by generating required returns as anticipated by its investors. Whereas ROE calculates the rate of return on shareholder's investment as equity in the organization (Qabajeh & Abdel Majid, 2012). Hence, ROI will be more appropriate in our conceptual model since it assesses company's overall profitability though it is rarely used in empirical research.

Moderating Variables

It is imperative to explore other factors which may affect the correlation between sustainability practices such as CSR or ESG and financial performance by obtaining data source from third party platforms (Rossi et al., 2021). It is also suggested by other scholars to consider other influencers or push factors who may or could be the potential positive moderators between ESG disclosure and firm value (Li et al., 2018).

For company to attract right talent to join the workforce even as part of board of directors' team, it is believed fair compensation has been linked to attracting right candidate with the required experience, expertise and competency to perform his or her duties in accordance with the demands and complexities of the organization. In adherence to this expectation from the strategic needs of the corporation, MCCG 2021 has addressed this concern by requesting listed firms to establish a proper remuneration committee to implement remuneration policies and procedures including reviewing and recommending matters pertaining to board remuneration as well as senior management (Securities Commission Malaysia, 2021). With this implementation of remuneration policy, the company is able to attract different talents to join the workforce to echo the promotion of diversity to provide more insight, latest ideas and inspiration in the board room discussion.

More stringent rules are expected from cross listed firms who have listed their shares in their home country but also have their stock being listed beyond their own countries in one of the foreign stock exchange markets. Therefore, cross-listed firms are anticipated to meet both securities from home and host countries. As a consequence, to magnify corporate financial returns, investors have to incorporate all the possible ESG risk and opportunities into their assessment risk and return checklist. To reduce their liability of foreignness in external capital market, cross-listed firms become more transparent in ESG reporting than those firms who merely have their shares listed in the home market (Yu & Luu, 2021). Additionally, foreign ownership also plays a significant role in supporting in disclosure of ESG performance (al Amosh & Khatib, 2021). Since, there is no advocation of foreign ownership as moderating role, thus, we would like to propose this for Malaysian market because most of the local businesses are family oriented, if the local company partners with foreign company as one of their associated or subsidiary companies, the knowledge about sustainability like ESG will be enhanced through the sharing and knowledge transferred from its headquarters based in overseas since there have been more research on sustainability related topics done in foreign countries especially western countries according to empirical research.

Besides board independence, whether independent director can exercise judgement and make strategic decision without being biased or due pressure from the closed family or group thinking, we feel that it is essential for any directors to be equipped with sustainability knowledge or even experience so that he can contribute extensively to rolling out and implementation of ESG practise in the company. Since ESG is new in developing countries like Malaysia, the ESG acronym may sound very abstract and complex to some of the directors due its wider spectrum and diversity, especially to companies with long serving directors or those firms owned by family owners. It is foreseeable it will be an issue for local firms to remain competitive in the global market, as a result, MCCG 2021 has included continuing learning as one of the reporting disclosures for listed companies. In order for directors to discharge their roles effectively, they should prepare themselves with well understanding and knowledge of sustainability topics pertinent to the company and its business activities. The board should observe its professional development needs concerning sustainability topics and ensure the shortcomings are properly addressed (Securities Commission Malaysia, 2021). As a result, we propose director with sustainability expertise as one of the moderating variables to reinforce the relationship of ESG disclosure on firm performance.

According to researcher, besides independent director, foreign owners are also able to give extensive support to ESG disclosure by being presence as part of independent board members and contribute strategic decision accordingly (al Amosh & Khatib, 2021). With foreign directors as part of the board of directorship, they are able to bring transformation to the committee with different insight due to their greater exposure in sustainability especially if they come from developed countries. Since board diversity will lead to more and new ideas, foreign director is another moderating factor to promote and support ESG disclosures. Therefore, to align to what is recommended by MCCG, board should consider structural change in board composition or mix of skills with the purpose to nourish board leadership and increase oversight of sustainability.

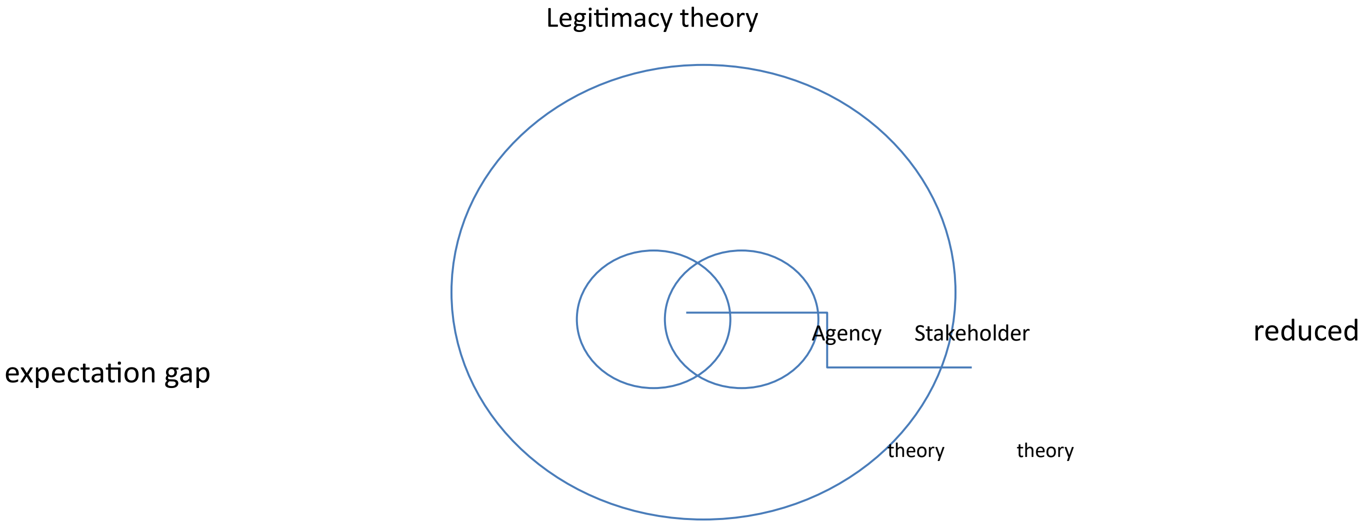

Figure 2 Overview of multi-theories to explain the ESG disclosure of listed firms in Malaysia

By meeting shareholder capitalist goal, the primary objective of engaging key positions such as directors as agents is to oversight the operation of the company on behalf of its shareholders. Because of this unique kind of arrangement between principal and the agents, conflict may arise from the disparity of interest between shareholders and management, inefficiency in resource management, misappropriation and misallocation of company's assets, all these factors result agency cost. To explain better the term of agency theory, the focus of agency theory stems from the assumptions that the agent will behave opportunistically, particularly if their interests collide with the principal (Mitchell & Meacheam, 2011).

Stakeholder theory is thoroughly different from agency theory. Stakeholder theory demands an equally and fair treatment from the company and the concept was initially developed by a man named Freeman in 1984. The argument is that the company owes duty of care to the society besides taking care of capitalism from shareholders. The company should pay attention to the general wellbeing of all her stakeholders (Deegan, 2002: Kee et al., 2020). Stakeholder theory is indeed an extension of agency theory, the key uniqueness of stakeholder theory is its concentration on a wider spectrum of interest by maintaining a firm relationship with existing and potential stakeholders, rather than just focusing on the needs of proprietary or economic interest of minority groups (Lourenço & Branco, 2013; Modugu, 2020). Hence, with the improvement of internal management practices stem from ESG disclosure, it has contributed by delivering a healthy relationship with multiple stakeholders including those who may have business dealings with the firms (Dhaliwal et al., 2011). Furthermore, ESG is able to narrow the asymmetric gap between principals, agents and stakeholders, ESG information can be employed as a channel to bridge the expectation and information gaps from various parties through detail, pertinent and transparent disclosure, to narrow or minimise the differences in terms of interest, information gap, expectation, goal and etc (Reverte, 2009; Modugu, 2020).

It is company's responsibility to assure the business is operating within the socially, legally regime and sustainable environment. Sustainability report such as ESG disclosure has been used as an instrument to meet its legitimate goals. Failing to meet legitimate requirements from various parties as concern will expose the company to a series of risks such as sanction of export sales and even survival of the company (Hayatun et al., 2012). Therefore, legitimacy theory has provided the other vibrant side of ESG disclosure.

Conclusion

This study has contributed to the empirical literature by proposing a conceptual model for Malaysia listed firm by introducing four different constructs which believed will strengthen the ESG disclosures and firm financial performance by producing transparent, reliable and pertinent sustainability reporting to deliver a more desirable financial objective. This study also considers various aspect of three different theories and suggests that for ESG to work effectively, the respective theories are agency theory, stakeholder theory and legitimacy theory, they must be treated as one family since they are interplay and depended on each other for the betterment of the company. With the implementation of ESG, it will definitely minimise the asymmetric gap between agency and stakeholder theory, furthermore, ESG practise has even emphasized and magnified the legitimated needs from principal, agent and stakeholders, to assure the company is running and meeting various expectations from different parties as concerned in a legitimate way.

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