

# MANAGEMENT & ACCOUNTING REVIEW

Volume 16 No. 2  
December 2017

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## Does Social Risk Management Matter? Influencing Factors and Their Link to Firms' Financial Performances

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### ABSTRACT

*This article deals with the growing pressures and demands for emerging risk reporting that may help interested users assess the importance of social risk management for sustainable development. The objectives of this study were to examine the influence of individual and institutional ownership and stakeholders on social risk disclosures and the joint effects on firms' financial performances. Content analyses on the 2013 and 2014 annual reports of all plantation sector companies were carried out and analyzed using partial least square (SEM\_PLS) software version 3.2. Based on the tests, we found significant relationships between institutional ownership and the number of stakeholders with social risk disclosures. However, there were no significant relationship between individual ownership and social risk disclosures. In addition, we found significant relationships between social risks and firms' financial performances. These findings reveal that institutional shareholders and the number of stakeholders had a significant influence in deciding the disclosure of social risk information. Interestingly social risk information was found to be statistically significant on firms' financial performance as measured by firms' net profits. This paper, therefore, endorses the growing demand to fully embed social risk management in companies' operations by both institutional shareholders and stakeholders in general.*

**Keywords:** Social Risk, Sustainability, Disclosure, Content Analysis, Malaysia

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#### ARTICLE INFO

##### **Article History:**

Received: 29 December 2016

Accepted: 25 August 2017

Available Online: 31 December 2017

1

## INTRODUCTION

Previous studies define or conceptualize social risk management (SRM) as social policy (Mckinnon, 2004), social protection (Holzmann & Jorgensen, 1999) and social policy or welfare state policy (Neubourg and Weigand, 2000). This paper concurs with the notion put forward by Neubourg and Weigand (2000), that SRM framework rests on the observation of the satisfaction of main needs; i.e. *“Individuals who are confronted with problem will react based on two basic elements; solve the problem at hand and take action to prevent the problem rising again”*. In particular, Neubourg and Weigand (2000) referred social risk management as *“focused on preventing contingencies to materialize, on mitigating the effects before they materialize and on coping with unfortunate moment bad luck, shocks or unfortunate events strike”*.

The state of art of SRM depends on a society’s ability to satisfy the need of its members and to manage the risks threatening the wellbeing of the same people that requires some individual and social actions. However, the ability to act and the possibility of realizing positive outcomes are subjected to uncertainties and may be threatened by risks. Accordingly, companies have developed various ways in dealing with these basic problems of society; thus, this study attempted to analyze and find out the extent of its relevancy and the related influencing factors.

Social risk, like any other risks, arises when companies’ own behavior or action of others, such as the stakeholders, in their operating environment creates vulnerabilities. Threats, uncertainties and related risks are and will remain an inevitable part of the operations carried out by people and organizations, and are a rising area of concern for global corporations (Kytile & Ruggie, 2005). Activity aimed at risk management has a long tradition in business practice and has been accompanied by the development of the theory of risk management since the early 1930s. Recently, a large body of research efforts is directed towards establishing integration between the ethical, social, environmental and economic performance within corporate social responsibility (CSR) reports (Adams & Frost, 2008). For example, Korosec and Horvat (2005) believed that the risk management theory has grown from its initial focus on only those threats and related risks but to improve the company’s overall position and its sustainable development.

This is evidenced from a rising number of articles that have been written on integrated risk management and enterprise risk management within the management, accounting and auditing disciplines (Korosec & Horvat, 2005). There is also recently greater pressure to report on threats that companies are likely to face and related risks and their management in corporate annual reports. For these reasons, the main purpose of this paper is to present the pressures, needs and demands for social risk reporting and management in corporate annual reports and to access the development of such reporting by plantation companies in Malaysia.

Social risk management (SRM) strategies, according to Kytle and Ruggie (2005), can be extremely complex undertakings that must account for and balance numerous conditions, perspective and variables across business enterprise. Kytle and Ruggie (2005) further argued that corporate social responsibility programs represent an excellent mechanism for addressing these challenges across business enterprises. Specifically, Kytle and Ruggie (2005) stated that,

*“CSR programs are a necessary element of risk management for global companies because they provide the framework and principles for stakeholders’ engagement, can supply a wealth of intelligence on emerging and current social issues/groups to support the corporate risk agenda, and ultimately serve as a counter-measure for social risk”.*

Thus, question posed in this study is, “What drives the SRM practices in plantation companies in Malaysia?” In order to address this question, this study integrated institutional and stakeholder views to develop a social risk management framework. We first reviewed the literature on SRM, the institutional and stakeholder theories, followed by hypotheses justification, discussions and conclusions.

## **LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT**

Satisfaction of needs requires some individual and social actions. According to Neubourg and Weigand (2000), there are three major institutions used

to satisfy needs and to take care of risks: (1) the market - not only refers to monetary transactions, but also to barter trade which includes corporation in this study, (2) the families - which include social network-based solidarity, and (3) the state which includes public authorities. In addition, Neibourg and Weigand (2000) sub-divided social risk management strategies into three, namely; preventive strategies, mitigation strategies, and coping strategies. Preventive strategies, which is the focus of this study, aimed at avoiding the risk by organizing economic and social life in such a way that the probability of a contingency is reduced. In addition, good governance and various CSR activities by corporations are important mechanisms under preventive strategies. Special attention is given to effective employment protection and regulation of labor contracts, since they protect at least the main income source for many individuals in an economy. These initiatives have a common fact that they intend to produce a less risky environment for the members of a society.

Holzmann and Jorgensen (1999) concluded four main reasons as to why social risk management is important, namely; (1) the fight against poverty; (2) improvement of consumption smoothing. It is believed that better arrangements to manage income risk does not only increase individual and societal welfare, but also improves welfare distribution in society, (3) improvement of equity as a major societal concern; and (4) the form of social risk management, which has an important bearing on economic development. Therefore, it is believed that a study on plantation companies in Malaysia will have a similar sense of responsibility towards societies in relation to social risk management activities.

Plantation companies in Malaysia were selected as the sample of this study because they were considered as a high risk industry. In a recent study, Vijay, Pimm, Jenkins and Smith (2016) on the impacts of oil palm on deforestation and biodiversity regarded the conversion of once tropical moist forests into oil palm to date, and future expansion, threatens biodiversity and increases greenhouse gas emissions. Additionally, high rates of forest loss for palm oil production across a range of countries and continents, raising concerns about future expansions of palm oil plantations. Specifically, Vijay et al. pointed out that palm oil was responsible for an average of 270,000 ha of forest conversion annually from 2000-2011 in major palm oil exporting countries. It was found that more than 50 percent of Indonesian



and Malaysian oil palm plantations in 2005 were on land that was forest in 1990 and some were disputed land with the natives. This legacy of forest loss according to the authors points to the need for increased monitoring and interventions with a particular emphasis in Indonesia, Malaysia and Papua New Guinea.

In order to examine the relationship in this study, the components of corporate social responsibility disclosure related risks were used as the proxy to social risk management. In general, previous studies on CSR had provided some insights to support the fact that CSR affects the value of firms. For example, Yang and Rivers (2009) used stakeholders and the institutional theories argument that managers must satisfy the constituents who could influence a firm's outcomes. It was argued that companies would likely adapt to local practices to legitimize themselves, in which they have to deal with very different institutional environments and demanding stakeholders. Concurring with Yang and Rivers (2009), this study used the stakeholder and institutional theories that identified internal and external pressures for legitimacy in plantation companies in Malaysia.

From the perspective of the institutional theory, this study used the percentage of shares owned by institutional shareholder (Inst SH) and percentage of shares owned by individual shareholders (Ind SH) as the proxies for institutional shareholders while the stakeholders theory was represented by total number of stakeholders (Stake). Yang and Rivers (2009) identified eight (8) key stakeholder groups that have salient influence on CSR. These includes (1) formal government institutions, (2) the community in which the company operates, (2) consumers, (3) Non-Governmental Organisations (NGOs), (4) industrial bodies, (5) consumers, (6) shareholders, (7) employees, and (8) parent firms. This study, however, focused only on the influence of shareholders. The reason behind our focus is that stakeholders can influence a company's SRM by directly controlling the flow of resources to the firm and taking indirect action against a target group of firm. This study also concurred with Yang and Rivers (2009)'s argument that shareholders can exercise direct influence on a company's CSR (and SRM in this study) attitude and practices by deploying two strategies; namely, (1) withholding strategy by stopping the flow of resources to the firm, and (2) usage strategy by limiting the way in which the firm can use resources.

In Malaysia, the newly amended companies Act 2016 (previously known as Companies Act 1965) puts the company's shareholders in a position of being the prime stakeholders, and they are able to extent substantial influence on managerial decision making. In countries where there are high degrees of protection and institutionalized good governance practices (such as mandatory reporting requirement), there is often low concentration of share ownership across a diverse group of shareholders See Yang & Rivers, 2009). Therefore, institutional shareholders are powerful because they hold a significant number of shares and so can directly influence the top management (Yang & Rivers, 2009). On the other hand, small shareholders, according to Yang and Rivers (2009), are usually discounted as being influential on a company's attitude to CSR but still have influence in some decision-making processes. In Malaysia, small shareholders, or particularly referred as individual shareholders in this study, usually play an important role as they often become one of the directors of the company, thus they have a significant influence on decision-making processes (Yang and Rivers, 2009).

Similarly, Holzmann and Jorgensen (1999) argued based on the shareholder value concept, that institutions in a competitive environment can also be efficient instruments to deliver public services financed by the public sector (such as job placement, social assistance payments, etc.). In particular, Holzmann and Jorgensen (1999) stated that the shareholder value concept leads them to better transparency and high efficiency by providing individuals nationwide with the broad variety of risk management instruments. As the issue of social risk management emerges as a result of private (asymmetric) information, the role of the institutions can be seen in their capacity to cope with information asymmetry.

Another important aspect in shareholders' demands on a company's attitude towards social risk is the emergence of socially responsible investing in developed countries. It is argued that shareholder groups are increasingly going beyond the decision to invest, not to invest, or to divest by proposing and voting on a company's decision at annual general meeting (Yang & Rivers, 2005). It is also argued that shareholders look at a company's internal operating behavior (such as employment policies and benefits) and external practices and policies, such as those having direct effects on the environment and indigenous people as well as their product line.

Hence, in relation to the stakeholders' influence, this study suggests the following hypotheses:

- H1:** Institutional shareholders provide a significant and direct effect on the quantity of social risk disclosures.
- H2:** Individual shareholders provide a significant and direct effect on the quantity of social risk disclosures.
- H3:** Stakeholders provide a significant and direct effect on the quantity of social risk disclosures.

In discussing the overall benefits of SRM, Ghazali and Weetman (2006) concluded that higher profitable firms disclose more information to signal that the companies are being managed and professionally run. Beliveau et al. (1994) further concluded that a firm's financial performance is only one component of its reputation and the executives from the firms who are doing well are highly regarded by potential employers. In general, Scantlebury & Alleyne (2015) believed that risk disclosures continue to be discussed and will likely remain a highly debated topic due to the major corporate scandals. They argued that such disclosures are likely to be the main tool shareholders and other interested parties use to assess a company and base their decisions.

According to Holzmann and Jorgensen (1999), the government has many important roles in the area of social risk management. These include:

(i) facilitating the set-up of financial market institutions; (ii) establishing the regulatory and supervisory framework, including a transparency requirement and consumer information; (iii) providing risk management instruments, where the private sector fails (unemployment insurance) or individuals lack the information for self-provisions; (iv) providing social safety nets and large scale transfers in the case of main or recurrent shocks; and (v) providing income distribution if the market outcome is considered unacceptable from a societal welfare point of view. To a certain extent, these roles indicate a relevant setting in Malaysia. The government encourages and makes it "a way of business" for companies to participate or initiate CSR programs. With regard to risk management

information, Amran (2009) commented that the Malaysian government, through various relevant parties, should devise the means to enhance companies' involvement in risk disclosures.

Generally, the literature has indicated a significant positive relationship between SRM and social risk disclosure. Thus, this study proposes the following hypothesis:

**H4:** Social risk provides a significant and direct effect on financial performance.

## RESEARCH METHOD

The sample for this study comprised all 42 plantation companies listed in Bursa Malaysia. Nevertheless two of the companies' annual reports were not available from their websites as they required a password to access, hence they were excluded from the sample. The data was collected using content analysis on social risk disclosure information for the financial year ended 31 December 2013 and the financial data for 31 December 2014. The dependent variable i.e the quantity of social risk disclosures, was measured based on the number of sentences. The annual reports were used in this study as they are deemed as relevant documents that are mandated to be produced every year and expected to provide useful information to users for better decision making (Amran, Rosli & Mohd Hassan, 2009). The data collection method used in this study is consistent with the recent study on risk management disclosure by Scantlebury & Alleyne (2015).

Contrary to previous studies, this study used the Partial Least Square – Structural Equation Modelling (PLS\_SEM) approach, which has been widely applied in the field of psychology, sociology, education, and marketing, but not in finance, accounting and economics (Saarani & Shahadan, 2011). PLS-SEM is a causal modelling approach aimed at maximizing the explained variance of the dependent latent constructs. This is contrary to covariance-based SEM (CB-SEM) objective of reproducing the theoretical covariance matrix, without focusing on explained variance (Hair, Ringle & Sarstedt, 2011). PLS is normally closely associated with the analysis of the latent construct in a survey-based research and has also

been used with data collected via other media including secondary data (Lee et al., 2011). In an editorial remark, Hair, Ringle, and Sartetd (2013) highlighted that the PLS\_SEM approach has enjoyed increasing popularity as a key multi-variate analysis, such as in the accounting discipline. The data for this study were analyzed using the SmartPLS® software version 3.2 developed by Ringle, Wende and Will in 2005.

Another justification why this research used the PLS\_SEM was to remedy some problems in other softwares. Accordingly, as highlighted by Saarani (2012), the lack of normality is a common issue in accounting-based measures. To overcome it, the statistical conversion technique, where the ratio is derived from the financial statements, is converted into likert scales. On the other hand, according to Wiseman and Wessels (1988), it has limitations of recognizing and mitigating measurement errors and other econometric problems that arise in studies involving estimation of latent variables, such as, interdependence among variables and failing to include more than one indicator for a latent variable (Saarani, 2012; Titman & Wessels, 1998).

## RESULTS AND DISCUSSION

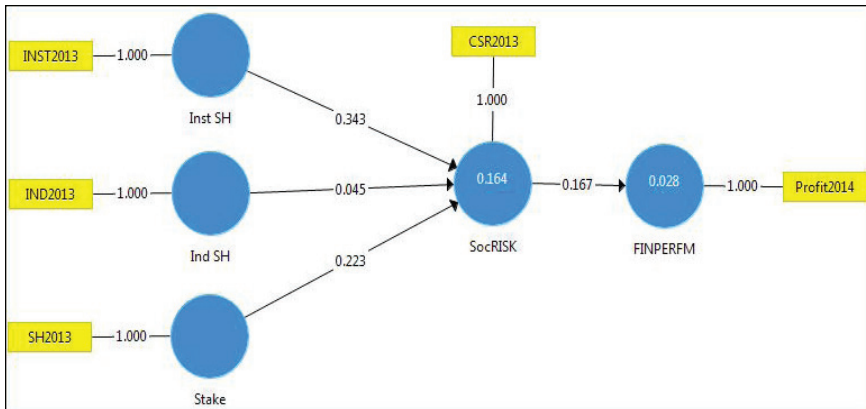
Two stages of analyses i.e the analysis of measurement and the analysis of structural model have been conducted in the SEM approach (also, Anderson and Gerbing, 1988). The measurement model was estimated using the confirmatory factor analysis to test reliability and validity of the measurement model, whilst the structural model was analyzed to assess magnitude of relationships among the constructs.

According to Gefen and Straub (2005), two elements of factorial validity need to be examined in PLS; namely, convergent validity and discriminant validity. This is because these are the components of a larger scientific measurement concept known as construct validity. Construct reliability will indicate adequate measurement of all constructs (Bagozzi & Edwards, 1998) and can be assessed by means of construct reliability, which requires indicators assigned to the same construct to show a strong mutual association. Therefore, Composite Reliability (CR) can be used to check how well a construct is measured by its assigned indicators. A

commonly acceptable threshold value for CR is 0.7 or more; however, values below 0.7 also have been considered acceptable (Hair et al., 2010). Nevertheless, a single item measure was used in this study because the data were extracted from secondary data (i.e. annual reports) and can be conceptualized as concrete and singular. Bergkvist and Rossiter (2007) argued that single-item measures are not theoretically based but rather are practical. Theoretically, Bergkvist argued that single-item is sufficient if (1) the object of the construct is “concrete singular”, which means it consists of one object that is easily and uniformly imagined, and (2) the attribute of the construct is “concrete,” again it means that it is easily and uniformly imagined. From the empirical-based argument, Bergkvist argued that single-item can be derived from the desire to avoid common method bias. Common method bias occurs when the correlation between two or more constructs is inflated because they are measured in the same way. Common method bias could occur within the multiple items of a multiple-item measure, and incidentally would inflate its coefficient alpha.

Convergent validity relates to the degree to which multiple items measure the same construct under study. A common approach to examine convergent validity is the factor loadings and Average Variance Extracted (AVE). The suggested threshold value of AVE should be above 0.50 as suggested by Bagozzi and Yi (1988). As discussed above, this study used single-item measure data, therefore, convergent validity was not an issue in this study.

The structural model indicates the causal relationships between the constructs in the model as presented in Figure 1.



**Figure 1: Explanatory Capacity of the Structural Model**

Assessment is done on the explanatory capacity of the model and the statistical significance of the various structural factors. Coefficient of determination, R<sup>2</sup> value and path coefficient (loadings and significance) indicate how well the data support the hypothesized model (Chin, 1998). The R<sup>2</sup> value for the relationship between the independent variables and social risk disclosures was 0.164, which indicates that 16.4% of the variance in social risk disclosures can be explained by percentage of shares owned by institutional and individual shareholders and the total number of stakeholders, which was considered moderate (Cohen, 1998). In addition, social risk explained 2.8% of the firms' performances as measured by net profits after taxation which was consider weak.

After evaluating the explanatory capacity of the structural model, the statistical significance of various structural coefficients was tested through the technique called bootstrapping (run with 40 cases and 5,000 samples) to generate a t-statistic value associated with each path. The outcome is shown in Table 1.

**Table 1: Results of Hypotheses Testing**

Hypotheses	Relationship	Beta	SE	t-value	Decision
H1	Inst SH -> SocRISK	0.368	0.161	2.126**	Supported
H2	Ind -> SocRISK	0.057	0.156	0.289	Not
H3	Stake -> SocRISK	0.287	0.13	1.717*	Supported
	SocRISK ->				
H4	FINPERFM	0.201	0.085	1.967*	Supported

\*\*p<0.01 (t-value > 2.33), \*p < 0.05 (t-value > 1.645)

The result showed that institutional shareholders and number of stakeholders had a significant t-value. Therefore, the hypotheses can be supported. The statistical results suggested that institutional shareholders will have a stronger influence on the quantity of social risk disclosures. Social risk disclosure is also found to have a significant relation with the firms' financial performances.

In terms of stakeholders, the results indicate that with a rising number of stakeholders, firms are giving more attention to social risk disclosures. This is consistent with the argument put forward by Yang and Rivers (2009), as well as Holzmann and Jorgensen (1999), that institutional stakeholders are powerful because they hold a significant number of shares and can directly influence the top management. The relationship between percentage of shares owned by individual shareholders and social risk disclosures was not significant. This finding further confirmed the argument made by Yang and Rivers (2009), that small shareholders are usually having less influential.

It is interesting to note that the relationship between social risk disclosures and firms' performances is positive and significant. Such a finding implies the firms' social risk disclosures have a significant influence on their profitability. The result is consistent with Ghazali and Weetman (2006), as well as Beliveau et al. (1999) concluded that higher profitable firms disclose more information to signal that the companies are being managed and professionally run. Generally, the findings of this study are also consistent with the argument by Scantlebury & Alleyne (2015) that risk disclosures continue to be discussed and will likely remain as a highly debated topic due the usefulness of such disclosures as it is likely to be the main shareholders and other interested parties to assess a company.



## CONCLUSION

This research aimed at examining the factors that influence social risk disclosures. The data were analyzed using partial least square modelling software version 3.2. This study used the data from the annual reports for the financial year ended 31 December 2013 and 2014 for both independent and dependent variables, respectively. This study used single-item measures to assess the constructs for both independent and dependent variables as they were conceptualized as concrete and singular. Therefore, the convergent and discriminant tests of the constructs were not applicable in this study. The results of the structural model indicate that institutional shareholders and number of stakeholders were the main determining factors influencing the social risk disclosures for plantation companies in Malaysia. In addition, the statistical evidence further confirmed that social risks had a significant impact on financial performances of the plantation companies in Malaysia.

As CSR is becoming a very important component in global business, many companies have incorporated CSR as part of their competitive global strategy, and now, they widely advertise their CSR initiatives. This study, however, went beyond CSR practices that provides empirical testing on SRM practices by plantation companies in Malaysia. Generally, this paper provides empirical evidence on how individual and institutional stakeholders in emerging market influence SRM action. Perhaps, future research should consider the question of how SRM by plantation companies can influence the operating environment of other listed companies.

Apart from that, this study adds to the limited prior empirical evidence in the area of sustainability risk and contributes to the body of literature on the empirical value of SRM and the influencing factors. It is in line with risk management information that call for the Malaysian government, through various relevant parties, to devise the means to enhance companies' involvement in risk disclosures Amran (2009). Nevertheless, this research was not without limitations. This research was based solely on plantation companies, therefore, the findings cannot be generalized to all Malaysian companies.

## ACKNOWLEDGMENTS

The authors would like to express their gratitude to the Accounting Research Institute and Fundamental Research Grants (FRGS) (Reference Code:FRGS/2/2014/SS05/UITM/02/18) for funding and facilitating this research project.

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