BOARD OF DIRECTOR DIVERSITY, CORPORATE SOCIAL RESPONSIBILITY DISCLOSURE AND FIRM PERFORMANCE IN MALAYSIA

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ABSTRACT

This study aims to determine whether board diversity influence the quality of Corporate Social Responsibility (CSR) disclosure. Board diversity in this study refers to heterogeneity in board gender, education level, education background, age, ethnic, tenure and nationality. This study also aims to examine the effect of quality of CSR disclosure on firm performance. In addition, it investigates whether quality of CSR disclosure mediate the relationship between board diversity and firm performance. Agency theory has been employed to support the linkage among board diversity, CSR disclosure and firm performance. The data was collected from annual reports of 200 selected companies listed in Bursa Malaysia from 2009 to 2013. Endogeneity problems had been remedied using two-stage least square. The results show that board diversity in education level and tenure positively influence the quality of CSR disclosure; gender, education background and ethnic diversity are insignificant on quality of CSR disclosure while age and nationality diversity show negative influence on the quality of CSR disclosure. The results suggest that board diversity does matter to quality of CSR disclosure and well balanced board is important in obtaining benefit from practicing board diversity agenda. Another finding revealed that quality of CSR disclosure was positively significant in affecting the firm performance. It was also found that quality of CSR disclosure mediated the relationship between board diversity (i.e education level, age, tenure and nationality) and firm performance. This indicates advantages for companies that produce a high quality of CSR disclosure and enable them to gain investors' confidence. The implication of this study provide insights to the implementation of the policy on board diversity and CSR disclosure in Malaysia.

KEPELBAGAIAN LEMBAGA PENGARAH, PENDEDAHAN TANGGUNGJAWAB SOSIAL KORPORAT DAN PRESTASI FIRMA DI MALAYSIA

ABSTRAK

Kajian ini bertujuan menentukan sama ada kepelbagaian dalam lembaga pengarah mempengaruhi kualiti pendedahan Tanggungjawab Sosial Korporat (TSK). Kepelbagaian lembaga pengarah di dalam kajian ini merujuk kepada kepelbagaian dari aspek jantina, tahap pendidikan, latar belakang pendidikan, umur, bangsa, tempoh perkhidmatan dan kewarganegaraan. Seterusnya kajian ini meneliti kesan kualiti pendedahan TSK terhadap prestasi syarikat dan mengkaji sama ada TSK bertindak sebagai *mediator* yang menghubungkan antara kepelbagaian lembaga pengarah dan prestasi syarikat. Teori Agensi digunakan untuk menyokong hubungan antara kepelbagaian lembaga pengarah, pendedahan TSK dan prestasi syarikat. Data dikumpul melalui laporan kewangan bagi 200 syarikat yang tersenarai di Bursa Malaysia bagi tahun 2009 hingga 2013. Masalah '*endogeneity'* telah diatasi dengan menggunakan analisis *two stage least square*. Hasil kajian mendapati kepelbagaian tahap pendidikan dan tempoh perkhidmatan mempengaruhi kualiti pendedahan TSK secara positif manakala kepelbagaian jantina, bangsa dan latar belakang pendidikan tidak mempengaruhi kualiti TSK. Sebaliknya, kepelbagaian umur dan kewarganegaraan menunjukkan kesan negatif terhadap pendedahan kualiti TSK. Dapatan kajian ini membuktikan bahawa kepelbagaian lembaga pengarah memberi impak yang berbeza terhadap qualiti pendedahan TSK. Justeru itu komposisi yang baik dalam pemilihan lembaga pengarah adalah penting bagi memastikan syarikat memperolehi manfaat dari perlaksanaan kepelbagaian pengarah. Hasil kajian seterusnya menunjukkan bahawa kualiti pendedahan TSK memberi kesan signifikan yang positif terhadap prestasi syarikat. Ini membuktikan syarikat yang mempunyai kualiti pendedahan TSK yang tinggi mempunyai kelebihan kerana ia mampu untuk meningkatkan keyakinan pelabur. Dapatan kajian menunjukkan TSK adalah *mediator* dalam perhubungan di antara kepelbagaian lembaga pengarah (iaitu tahap pendidikan, umur, tempoh perkhidmatan dan kewarganegaraan) dan prestasi syarikat. Implikasi kajian ini ialah ia menyumbang kepada kefahaman terhadap perlaksanaan dasar kepelbagaian lembaga pengarah dan pendedahan TSK di Malaysia.

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2SLS	2 stage least square
CSR	Corporate Social Responsibility
EPS	Earning Per Share
ESI	Environmentally Sensitive Industry
EVA	Economic Value Added
GMM	General Method of Moment
GRI	Global Reporting Index
OLS	Ordinary Least Square
IPC	Infrastructure Project Company
IV	Instrumental Variable
MCCG	Malaysian Code of Corporate Governance
NACRA	National Annual Corporate Report Awards
NOPAT	Net Operating Profit After Tax
NPM	Net Profit Margin
PLC	Public Listed Companies
ROA	Return on Asset
ROE	Return on Equity
VIF	Variance Inflation Factor
WACC	Weighted Average Cost of Capital

CHAPTER 1

INTRODUCTION

1.0 Introduction

This chapter begins with the background of the study whereby it discusses a concept of corporate governance and Corporate Social Responsibility (CSR) disclosure. The problem statement for the study will be elaborated in the second section of this chapter. The next section in this chapter identifies the research objectives and research questions. The relevance of conducting research on board diversity, CSR disclosure and firm performance also will be justified in this chapter. Subsequently this chapter includes the significance of the study, conceptual framework, scope of study and definition of terms. Finally, it ends with the summary of this chapter.

1.1 Background of Study

Corporate governance has succeeded in attracting a good deal of public interest because of its apparent importance for the financial health of the company and society (Abdul Rahman, 2009). It has been emphasized that good governance is able to gain investment capital, reduce risk management and improving the companies' performance (Ajanthan, 2013). According to Ehikioya (2009), accountability and transparency are the pillars that build up a good corporate governance. Accountability and transparency in corporate governance can be discharged by disclosing information to the stakeholder.

Disclosure of information has turned crucial after the increasing corporate scandals and financial crisis (Neifar & Halioui, 2013). Beekes, Brown, Zhan, and Zhang (2012) found that disclosure of information is an important feature of an efficient capital market as it enables investor and creditors to obtain a better understanding of the firm's activities. Disclosure acts as a communication channel between the corporation and their stakeholder. It enables investors to come closer to the company's affair and hence reduce the gap between the management and investors (Akhtaruddin, Hossain, Hossain & Yao, 2009). Meeampol, Rodpetch, Srinammuang, and Wongsorntham (2013) highlighted that the task to ensure the quality and reliability of the information disclosed is borne by the corporate governance of the firm. History shows that many corporate governance scandals have led to the misleading information disclosure such as Enron, WorldCom, Lehman Brothers and Satyam Computer Services Ltd. As a response to corporate governance scandals, tougher disclosure requirements have been imposed (Hermalin & Weisbach, 2012). The corporations are not only obliged to disclose their financial information but in recent years they are also responsible to disclose their non-financial information. One of the non-financial information reported by the company is CSR information. CSR disclosure is an extension of the financial disclosure system, which reflects the wider anticipation of society concerning the role of the business community in the economy (Bayoud, 2012). Specifically in Malaysia, with effect from 31st December 2007, Malaysian public listed companies (PLC) are mandatory to disclose the CSR information in the annual report. In addition, the Sixth Prime Minister of Malaysia, Dato Seri Mohammad Najib Bin Abdul Razak, at the Sustainability and Diversity Roundtable Session (2014) had urged the Malaysian listed companies to disclose the CSR information to enable the companies in Malaysia to be in line with the international best practice in reporting.

Evidence shows that the investors see social and environmental information as an important tool in making investment decisions and hence demand adequate disclosure of such information (Yekinni, 2008). Information on human rights policies, corporate environmental performance, corporate philanthropy, diversity policies and human resource development are important indicators of corporate values. According to Bayoud and Kavanagh (2012), managers disclose CSR information because the practice affects business performance and build a positive corporate image. Owing to the benefit of disclosing CSR information, 95% of 250 largest companies in the world had reported their CSR activities (KPMG, 2011). The increasing attention on CSR also attracted researchers to conduct studies on various aspects of CSR areas. However, there are research gaps that have not been addressed in CSR field and it will be discussed in the following section.

1.2 Problem Statement

The first research gap derived from the standard setting on CSR disclosure in Malaysia. The mandatory[1] requirement of CSR information disclosures in Malaysia does not

[1]Mandatory disclosure is information revealed in the fulfilment of disclosure requirement of statute in form of laws, professional regulations in the forms of standards and the listing rules of stock exchange (Katmun, 2012)

provide detail guidelines on the specific information to be disclosed by the companies but rather gives companies the flexibility to provide information relating to their CSR activities (Ahmed Haji, 2013). The Bursa Malaysia Listing Requirement in Appendix 9C Part A – Contents of Annual Report (paragraphs 9.25 and 9.41) item 29 stated that the company are required to provide *"A description of the corporate social responsibility activities or practices undertaken by the listed issuer and its subsidiaries or if there are none, a statement to that effect".* The flexibility in disclosing the CSR information lead to the differences in information provided by the companies. Some companies may voluntarily disclose extensive information while others disclose brief information on CSR disclosure. Such differences driven to difference in quality of CSR disclosure provided by the companies. Taking into consideration on voluntary disclosure, the present study focus on the quality of CSR disclosure. This is because the current practice of CSR disclosure has been badly criticized (Ping, 2012). It was highlighted by previous literature that the CSR reports have failed to fulfill the expectation from stakeholders, unable to meet the readers desires (Hąbek & Wolniak, 2015) and most of the CSR reports are of poor credibility (Giordano, 2010; Ahmed Haji, 2013). The importance of high quality disclosure has been notable by previous literature (Katmun, 2012; Zahller, Arnold, & Roberts, 2015). However, most of the previous studies measured the extent of CSR disclosure[2] and ignore the measurement

[2]Extent of disclosure was measure using dichotomous method whereby a company is awarded a score of '1' if an item included in the checklist and '0' if it is not disclosed (Abdul Razak & Mustapha, 2013; Khan, Mutakin, & Siddiqui, 2012; Mohd Ali & Hj Atan, 2013; Rusmanto, Waworuntu, & Syahbandiah, 2014) or by counting number of words, sentences, paragraph or pages (Menassa, 2010; Rahman, Hashim, & Bakar, 2010; Tamby Chek, Mohamad, Yunus, & Mat Norwani, 2013).

for quality of disclosure[3] (Taha, 2010). Limited research was conducted in Malaysia on quality of CSR disclosure[4].

The current study measures the quality of CSR disclosure based on the weighted score as suggested by previous literature (Darus, Hamzah, & Yusoff, 2013; Ahmed Haji, 2013; Saleh, Zulkifli, & Muhamad, 2011).This measurement is straightforward and can be verified (Sutantoputra, 2009). Although prior studies used Global Reporting Initiative (GRI) in measuring the quality of CSR disclosure, it was argued that it does not create expectation inherent in voluntary disclosure of economic-based (Zahller et al., 2015). Furthermore, in GRI, companies are free to choose from the guidelines in any way they prefer and this contributes to the difficulty in assessing the CSR disclosure quality (Romolini, Fissi, & Gori, 2015).

The second research gap derived from the board diversity agenda in Malaysia. The first step taken in order to achieve board diversity agenda in Malaysia is to have greater participation of women at directorial level announced in year 2010[5]. The emphasis on board diversity agenda continues when Bursa Malaysia Berhad had vide its letter dated 22 July 2014 (“Letter”) clarified that a listed issuer is required to disclose in the annual reports issued on or after 2 January 2015, its diversity policy for its Board of Directors and workforce in terms of gender, age and ethnicity as part of the enhanced disclosure requirements to Paragraph 15.08A of the Main Market Listing Requirements

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[3]In measuring the quality of CSR disclosures, a checklist on the index items was provided and weighting are assign to the item.

[4] Research on quality of CSR disclosure was conducted by Saleh, Zulkifli, and Muhamad (2010), Mohamad et al., (2014), Darus et al. (2013); Abd-Mutalib, Jamil, & Wan-Hussin (2014) and Haji (2013).

[5] In 2004, the then Prime Minister, Abdullah Badawi, announced a policy which stipulated that 30 percent of the decision makers in all sectors of the economy should be women. The deadline for the 30 percent target to be achieved in the public sector was set as 2010. As a continuation of this policy, in June 2011, Prime Minister Mohammad Najib Tun Abdul Razak announced that listed companies had until 2016 to ensure that at least 30 percent of their board members are women (Abdullah & Ismail, 2013).

of Bursa Malaysia Securities Berhad. Diversity in boards has been receiving growing attention for several years, as one of the most significant issues currently in corporate governance (Mahadeo, Hanuman & Soobaroyen, 2011). However, less empirical research on board diversity was conducted in developing countries (Jamali, Safieddine & Daouk, 2007; Zainal & Zulkifli, 2013). Most of the empirical research on board diversity was mainly derived from the developed countries' perspective, such as the United States (Gul, Srinidhi & Ng, 2011), the United Kingdom (Brammer & Pavelin, 2008) and Australia (Nguyen and Faff, 2006). More evidence should be drawn from the developing countries, specifically from Malaysia. This is because different culture, political influence and economic condition that exist in Malaysia may have different effect on board diversity policy compared to developed country. For example, Malaysia firms that operated in multi-ethnic environment need to be more diverse in terms of board ethnic composition than those other countries that predominantly populated by single ethnic group such as United Kingdom and United States (Abdullah & Ismail, 2013). With regards to this study, the diversity in boards of directors is likely to influence the quality of information disclosure as a more diverse board of directors would be able to make decisions based on the evaluation of more alternatives compared to a more homogeneous board (Ayuso & Argandoña, 2007). However, there are lack of research on board diversity and CSR disclosure in Malaysia[6].

The third research gap derived from the findings of previous literatures that reported ambiguous relationship between CSR disclosure and board diversity with firm performance. The relationship between CSR disclosure and financial performances is

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[6] Research on nationality and CSR disclosure by (Che Ahmad & Osazuwa, 2015); board independence, board diversity and CSR on Earning Management (Mohamad, Abdullah, Mohktar, et al., 2010)

still controversial and open for further research (Wijesinghe & Senaratne, 2010). In addition, although board diversity was posited to add value to firms (Bathula, 2008), the empirical study on the association between board diversity and firm performance is inconclusive (Vafaei, Ahmed & Mather, 2015). The different findings might come from various measurement used. The literature review conducted by Fiori, Donato, and Izzo, (2009) reveals that the measurement of firms' financial performance can be based on profitability, liquidity, solvency, financial efficiency and repayment capacity. In this study, Economic Value Added (EVA) will be used to measure the firm's performance besides Tobin Q. According to Nur'ainy, Nurcahyo and Sugiharti (2013) EVA gives a good measurement system for assessing the performance and financial performance of management because EVA is directly related to a company's market value. EVA is the financial performance measure that comes closer than any other to capture the true economic profit of an enterprise (Shil, 2009). EVA, which is a value based measurement, has gained attention in the developed countries, but it is still behind in the developing countries which are using value based performance measures as firm performance measurement tools (Mamun & Mansor, 2012).

The forth research gap derived from the possibility that the quality of CSR disclosure may become a mediator in the relationship between board diversity and firm performance. Prior studies have investigated the direct effect between board diversity and firm performance (Abdullah & Ismail, 2013; Fan, 2012; Julizaerma & Mohamad, 2012; Marimuthu & Kolandaisamy, 2009; Ujunwa, Okoyeuzu, & Nwakoby, 2012). Nevertheless, their findings shows mixed results and this trigger the existence of indirect effect mechanism to explain the association between board diversity and firm performance. However, little is known on the indirect effect in this board diversity and firm performance relationship. Within this debate, the literature witnessed the direct effect of board diversity on CSR disclosure (Feijoo, Romero, & Ruiz, 2012; Handajani, Subroto, & Erwin, 2014) and CSR disclosure on firm performance (Bayoud & Kavanagh, 2012; Tjia & Setiawati, 2012). Thus, it delineates that there are association among board diversity, quality of CSR disclosure and firm performance. Accordingly, this study offers quality of CSR disclosure as a potential mediator of the board diversity and firm performance relationship.

1.3 Conceptual Framework

The independent variable for this conceptual framework is board diversity which comprise of board gender diversity, board education level diversity, board education background diversity, board age diversity, board ethnic diversity, board tenure diversity and board nationality diversity. The board diversity was hypothesized to be associated with quality of CSR disclosure and firm performance. Concurrently, it is suggested that quality of CSR disclosure may influence firm performance and act as a mediator variable that link the board diversity - firm performance relationship. The firm performance is the dependent variable and measured using Tobin Q and Economic Value Added (EVA). Below is the explanation for the association between independent variable, mediator variable and dependent variable.

The first association in the above conceptual framework is between board diversity and quality of CSR disclosure. According to Bonsón and Bednárová (2014) firms disclose CSR information to reduce the information asymmetry. However, Muttakin, Khan and Subramaniam (2015) argued that firms provide more CSR activities so that their opportunistic behaviour and corporate misconduct is over-shadowed by the CSR disclosure. In order to mitigate such situation and to enhance the quality of CSR disclosure it is suggested to have board diversity. A diverse board may bring new idea, better problem solving and accountable for CSR implementation (Handajani et al., 2014) as diverse board equipped with heterogeneity in skills, background and expertise.

The second association is between quality of CSR disclosure and firm performance. CSR disclosure is viewed as an element of transparency whereby it allows the stakeholders to access the company's information particularly when they do not have direct access to the information (Carroll & Einwiller, 2014). Therefore, it reduce the agency problem, reduce cost of capital and influence the firm value by increasing the actual cash flow that accrued to the shareholders (Hassan, Romilly, Giorgioni, & Power, 2009).

The third association is between board diversity and firm performance. In the corporate world, there has been anecdotal evidence from some large corporations such as IBM, Ford Motor, Nortel, Lucent, Sara Lee, Texaco, and DuPont that board diversity has been cited as an imperative for business success (Fan, 2012). Campbell and Mínguez-Vera (2008, p. 439) argued that greater board diversity increases a firm's competitive advantage relative to firms with less diversity. However, contradict to that; board diversity lead to slower decision making and increase the conflict among diverse directors (García-meca, García-sánchez, & Martínez-ferrero, 2015). Following the argument, there are no consistent relationship that can be concluded between board diversity and firm performance. The inconsistent results on direct effect between board diversity and firm performance relationship offers researchers to examine the indirect effect of such relationship (Kinkel, 2014; Miles & Erhardt, 2014). In light with this argument, the current study employed a mediating variable to explain the indirect effect and presented as the forth association in this conceptual framework.

The fourth association in the conceptual framework is the role of quality of CSR disclosure as a mediator for board diversity and firm performance relationship. The selection of quality of CSR disclosure as mediator variable rests on the assumption that board diversity generate better quality of CSR disclosure and in turn, quality of CSR disclosure leads to better firm performance. Within CSR literatures, previous studies have employed CSR disclosure as a mediator to explain the relationship between financial resources, corporate capabilities and corporate characteristics with environmental performance (Muliati, Pagalung, Harryanto & Pontoh, 2014); CSR activities as a mediator in examining the relationship between board independence and firm value (Fernandez Gago, Cabeza Garcia, & Nieto, 2016); CSR ratings mediates the linkage between board resource diversity and gender composition with corporate reputation (Bear, Rahman, & Post, 2010); and CSR practices as a mediator in the association between top management diversity and firm performance (Miles & Erhardt, 2014).

Besides that, the conceptual framework includes board mechanism (board independence, board size and frequency of board meeting), audit committee characteristics (size of audit committee, independence audit committee and frequency of audit committee meeting) and firm characteristics (company size, Big 4 company, loss company and leverage) as control variables.