

CHAPTER I

INTRODUCTION

A. Background

In the modern era like today, companies in the world are required to compete more tightly with the dynamics of faster change. This condition tends to make companies carry out massive and fast business activities without concerning the social sustainability and causing environmental problems. The increasing level of social and environment issues are happening around the world, including in Indonesia and the Philippines.

Indonesia and the Philippines have almost the same environmental problems. One of the big problems faced by these two countries is plastic waste. In 2021, the Philippines is ranked third as the country with the most plastic waste pollution while Indonesia is ranked fifth as the country that release the most plastic waste into the sea (Meijer et al., 2021). One of the reasons for this large amount of plastic waste pollution is the company's lack of understanding of social sustainability and corporate disclosure. For example, the manufacture of product packaging that is difficult to recycle causes plastic waste to be difficult to decompose and increases plastic pollution levels. If it is allowed to continue, plastic waste pollution will change natural processes and damage social well-being.

Moreover, one of the biggest environmental problems in Indonesia are caused by PT Freeport's activities. According to Aksi Ekologi & Emansipasi Rakyat et al., (2020), PT Freeport has disposed mining waste into the Yamaima and the Okorpa Rivers and therefore rivers in Papua are polluted by mining waste. The water at the sample locations contained high concentrations of Phosphate (has concentration of 3.7 mg/L from 0.2 mg/L standard quality), Cyanide (has concentration of 0.022 mg/L from 0.020 mg/L standard quality), Iron (has concentration of 5.55 mg/L from 0.3 mg/L standard quality), Copper (has concentration of 1.87 mg/L from 0.02 mg/L standard quality), and Zinc (has concentration of 0.52 mg/L from 0.05 mg/L standard quality). The river in Okorpa River is also shown to experience an increase in suspended level of solids. This is proven by the result of measurement in Okorpa River that has the result of 78 mg/L while the normal level of the quality standard is 50 mg/L. Moreover, according to Badan Pemeriksaan Keuangan Republik Indonesia's Financial statement report in 2018, the environmental damage caused by PT Freeport Indonesia is around \$13 billion.

Stakeholder theory can be used as a solution to environmental problems that occur. Stakeholder theory concerns the company's relationship with its stakeholders and therefore it requires companies to pay attention to the interests of stakeholders. Furthermore, one form of implementation of stakeholder theory that can be used to overcome environmental problems is Corporate Social Responsibility (CSR) disclosure. CSR disclosure is important because it

can improve the controlling function within the company. CSR disclosure will require the company to show ethical and social responsibility through transparency to different stakeholders.

However, the level of CSR reporting in Indonesia and the Philippines still tends to be low when compared to the level of global reporting. In general, companies in the Philippines and Indonesia are aware of economic components in CSR. However, most companies in the Philippines and Indonesia are currently unaware of other CSR aspects such as environment and social aspects. Although the level of CSR reporting in Indonesia and the Philippines is still low, there is an increase in the level of CSR disclosure every year (Ridho, 2018). Based on the explanation, it can be concluded that the level of transparency regarding company activities in Indonesia and the Philippines is still low, even though transparency is a very important aspect.

Based on the principles put forward by the Organization for Economic Co-operation and Development (OECD), transparency is one of the core values that build the corporate governance framework. Transparency itself means that all material matters concerning company disclosures are made in a timely and accurate manner, including its financial situation, governance structure, performance, and ownership (OECD 2015). Therefore, transparency is related to stakeholder theory due to increasing transparency within a company, the stakeholders' interests will be fulfilled. Investors and other stakeholders benefit from the opportunity to gain insight into the company's business operations and

financial data. Even if the information provided shows negative results, stakeholders will benefit from the decreased risk of uncertainty (Otoritas Jasa Keuangan, 2014).

The transparency carried out by companies through disclosure is in line with the word of Allah SWT in Q.S Al. Baqarah verse 143.

وَكَذَلِكَ جَعَلْنَاكُمْ أُمَّةً وَسَطًا لِتَكُونُوا شُهَدَاءَ عَلَى النَّاسِ وَيَكُونَ الرَّسُولُ عَلَيْكُمْ شَهِيدًا ۗ وَمَا جَعَلْنَا الْقِبْلَةَ
الَّتِي كُنْتُمْ عَلَيْهَا إِلَّا لِنَعْلَمَ مَنْ يَتَّبِعِ الرَّسُولَ مِمَّنْ يَنْقَلِبُ عَلَى عَقْبَيْهِ ۗ وَإِنْ كَانَتْ لَكَبِيرَةً إِلَّا عَلَى الَّذِينَ هَدَى
اللَّهُ ۗ وَمَا كَانَ اللَّهُ لِيُضِلَّ إِيْمَانَكُمْ ۗ إِنَّ اللَّهَ بِالنَّاسِ لَرَّءُوفٌ رَحِيمٌ

“And it is thus that We appointed you to be the community of the middle way so that you might be witnesses to all mankind and the Messenger might be a witness to you”

The verse above explains that Muslims are made fair in obtaining and conveying choices, including in conveying disclosure. Muslims will be witnesses to the actions of people who deviate from the truth both in this world and in the hereafter.

The role of corporate governance mechanism, especially the board of directors, audit committees, and ownership structure to CSR disclosure is very important. Based on the previous research conducted by Ridwan and Mayapada (2020), the board of directors generally has responsibility for managing the company, implementing and supervising the implementation of the principles of good corporate governance within the company, preparing a business plan,

and establishing and communicating strategic policies to all stakeholders. Furthermore, the audit committee has the main responsibility to ensure that the company's financial reports are prepared and delivered accurately and timely, and thus the information asymmetry between company management and stakeholders can be minimized. Moreover, according to Jensen and Meckling (1976), the ownership structure is important because it affects the managers' decision, including the decision regarding CSR.

Prior research regarding the influence of corporate governance mechanisms to CSR disclosure has been done in many countries. Research conducted by Agarwala, Pareek, and Sahu (2022) in India found that board size has a negative effect on CSR disclosure. Another study conducted by Uyar et al., (2021) who took samples of global companies in healthcare sector also found that board size has negative effect on CSR disclosure because larger board size will raise a communication issue and delay decision making. Furthermore, previous studies conducted by Fauzyyah and Rachmawati (2018) in Indonesia and research by Naseem et al., (2017) in Pakistan have proven that board meetings have a positive effect on CSR disclosure because they indicate board discipline and efficient problem solving.

The positive effect of audit committee size on CSR disclosure has also been proven by research conducted by Madi, Ishak, and Manaf (2014) in Malaysia and study by Harvidiyan and Dianawati (2020) in Indonesia. It is believed that audit committee size to CSR has positive effect because larger

audit committee size will increase the monitoring level and enhance the reporting accountability. Previous study conducted in Korea by Ryu, Chae, and Song (2021) proved that audit committee expertise has positive effect to CSR disclosure because audit committee experts are believed to be able to create synergy through the combination of expertise types. The study conducted by Akhtaruddin and Haron (2010) in Malaysia also found the positive effect of audit expertise to CSR disclosure.

Moreover, the positive effect of managerial ownership to CSR disclosure has been proven by Fauzyyah and Rachmawati (2018) in Indonesia and supported by a study conducted by Novitasari and Bernawati (2020) who also took samples in Indonesia. The positive effect between managerial ownership and CSR disclosure is because managers have a high sense of ownership of the company and therefore they are willing to continue to improve the quality of the company. The previous study conducted by Nurleni et al., (2018) in Indonesia found that institutional ownership has positive effect to CSR disclosure because institutional investor has better understanding of the importance of CSR disclosure. The positive result between institutional ownership and CSR disclosure is supported by other study conducted by Fauzyyah and Rachmawati (2018) also in Indonesia. Further, the study of Indian companies conducted by Saini and Singhania (2019) found negative effect of foreign ownership to CSR disclosure and it is supported by other study conducted by Zulvina et al., (2017) in Indonesia. The negative effect of foreign

ownership to CSR disclosure is because foreign ownership focuses more on profit making than social sustainability.

This study focuses on the effect of corporate governance mechanism on CSR disclosure in shariah companies in Indonesia and the Philippines. Shariah companies are companies whose business activities, types, and management are based on Sharia Principles. The choice goes to Indonesia and the Philippines because they have growing number of shariah companies and therefore it is expected to represent a general picture of the development of shariah companies in the world, particularly about corporate governance and CSR disclosure.

The increase in sharia companies in Indonesia is motivated by Indonesia's status as the world's largest Muslim-majority nation, thereby the demand of the Muslim community for shariah companies is increasing. The increasing number of shariah companies in Indonesia can be seen from the continued increase in the number of companies registering in the sharia capital market. According to Indonesia Stock Exchange (2022), the number of sharia companies in Indonesia in 2022 is 493 companies, an increase of 67 companies from 2021.

Meanwhile, the increasing number of the Philippines' shariah companies is proven by The Philippines Stock Exchange (2022) statement that currently there are 65 shariah-compliant firms in the Philippines, an increase of 9 firms from the previous year. The increase in shariah companies firms in the Philippines is motivated by 4 factors, namely the desire to facilitate the needs of the Muslim people in the Philippines, the ASEAN integration, the

opportunity to broaden the market through the international financial market, and the need to find a solution for Al Amanah Bank – an existing Islamic bank with a record of poor performance (Mylenko and Iqbal 2016). Thus, it is hoped that these two countries can represent the shariah companies.

This study is a compilation of previous studies (Fahad and Rahman, 2020; Fauzyyah and Rachmawati, 2018). This study aims to examine the effect of the board of directors meeting and audit committee size on CSR disclosure as an advanced study from Fahad and Rahman (2020). The study conducted by Fahad and Rahman (2020) has a sample in India and examines the variables such as board age, audit committee size, board meetings, CEO duality, board independence, employee CSR training, independent directors, sustainability committee, and women in the board. The previous study finds that the board meeting has no significant effect on CSR disclosure and the size of the audit committee is inversely related only to the environmental disclosure score.

Moreover, this study also examines other variable such as board size, managerial, foreign, and institutional ownership as a continuation of a study conducted by Fauzyyah and Rachmawati (2018). The previous study examines the number of meetings conducted by the board of directors, independent commissioners, audit committee, and managerial, foreign, and institutional ownership in manufacturing companies in Indonesia. The study found that corporate governance mechanism such as the board of directors meetings, independent commissioners, audit committee, foreign ownership

concentration, public ownership, institutional ownership, and the size of board commissioners have positive influence on the disclosure of CSR. However, the managerial ownership, proportion women in the commissioners, and the environmental performance do not influence the CSR disclosure.

However, the previous studies have not examined the effect of corporate governance mechanism such as the size of the board of directors, the frequency of the board of directors meeting, audit committee size, audit committee expertise, managerial ownership, institutional ownership, and foreign ownership on shariah companies in Indonesia and the Philippines. Therefore, this study aims to analyze the effect of the board of directors, audit committee, and ownership structure as corporate governance mechanism to CSR disclosure in shariah companies in Indonesia and the Philippines, except the financial sector.

B. Formulation of the Problem

The implementation of the good corporate governance mechanism is expected to encourage companies to improve the quality of corporate information disclosure every year. Thus, the formulation of the questions compiled is as follows:

1. Does the size of the board of directors have negative effect on CSR disclosure in shariah companies in Indonesia and the Philippines?
2. Does the frequency of the board of directors meeting have positive effect on CSR disclosure in shariah companies in Indonesia and the Philippines?

3. Does the size of the audit committee have positive effect on CSR disclosure in shariah companies in Indonesia and the Phillipines?
4. Does the expertise of audit committee have positive effect on CSR disclosure in shariah companies in Indonesia and the Phillipines?
5. Does managerial ownership have positive effect on CSR disclosure in shariah companies in Indonesia and the Phillipines?
6. Does institutional ownership have positive effect on CSR disclosure in shariah companies in Indonesia and the Phillipines?
7. Does foreign ownership have negative effect on CSR disclosure in shariah companies in Indonesia and the Phillipines?

C. Research Purpose

The purpose of this study is to examine:

1. The negative effect of the size of board of directors on CSR disclosure in shariah companies in Indonesia and the Philippines
2. The positive effect of the frequency of board of directors meeting on CSR disclosure in shariah companies in Indonesia and the Philippines.
3. The positive effect of the size of the audit committee on CSR disclosure in shariah companies in Indonesia and the Phillipines.
4. The positive effect of the expertise of audit committee on CSR disclosure in shariah companies in Indonesia and the Phillipines
5. The positive effect of managerial ownership on CSR disclosure in shariah companies in Indonesia and the Phillipines

6. The positive effect of institutional ownership on CSR disclosure in shariah companies in Indonesia and the Phillipines
7. The negative effect of foreign ownership on CSR disclosure in shariah companies in Indonesia and the Phillipines.

D. Benefit of the Research

The research has contribution on both theoretical and practical aspects.

1. Theoretical Benefits,

The study contributes to a better understanding on how corporate governance mechanism affect the CSR disclosure in Indonesia and the Phillipines shariah companies.

2. Practical Benefits,

The study replenishes empirical results on the impact of corporate governance mechanism on the disclosure. This study is expected to give contribution to the following parties:

a. Company

The study is expected to assist companies in making decisions regarding corporate governance and CSR disclosure.

b. Policy maker

The study is expected to convey to policy makers about the importance of disclosure and the factors that influence it from the perspective of corporate governance mechanism.

c. Society

The study is expected to provide practical benefits to society through its role in controlling business operations.

d. Investor

The study can give practical benefits to investors through reporting on business activities in social, economic, and environmental aspects. Thus, the investors can take appropriate decisions.