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Explicating the Corporate Governance Mechanisms of Shari’ah Compliant Companies

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Abstract
The paper attempts to assess and examine the disclosure of the mechanisms of the corporate governance (CG), namely, board matters, nomination matters, audit matters, remuneration matters, communication matters, and risk management matters, of Shari’ah Compliant Companies (ShCCs) for a six-year period from 2008 until 2013. By using the weighted disclosure analyses approach, CG index was developed. The study examines the annual reports of a sample of 1,122 ShCCs which was selected based on the top 500 firms (by market capitalisation) for 2008 until 2013. In this study, SPSS was applied to assess the CG disclosure. Based on the descriptive analysis, the result indicates a remuneration matters (mean: 0.55) score higher than the other mechanisms; this was followed by audit matters (mean: 0.49). The study also found that, the average disclosure level of ShCCs was relatively low. Hence, the result has important implications for the enhancement of the CG disclosure of ShCC for a wider acceptance and reputation enhancement.

Keywords: Corporate Governance, MCCG, Shari’ah Compliant Companies, Board Matters, Nomination Matters, Audit Matters, Remuneration Matters, Communication Matters, Risk Management Matters.

Introduction
Corporate governance (CG) issues have become a significant topic in Malaysia and globally. This followed from the 1997 Asian financial crisis (Shamsul Nahar, 2001), the scandals of high profile companies, such as Enron, WorldCom, Tyco, and other firms in the US (Raphaelson and Wahlen, 2004), and also corporate scandals of companies in Malaysia, such as Perwaja Steel, Sime Darby,
Technology Resources Industries Berhad, Malaysia Airlines and Tabung Haji. These corporate scandals have had an adverse effect on many parties, either directly or indirectly. Hence, effective CG is the key mechanism and should play a strong role to prevent the reoccurrence any corporate scandals. CG also plays a vital role in underpinning the integrity and efficiency of the capital market. Therefore, several initiatives had been introduced and put in place by the Malaysian government after the 1997 Asian financial crisis in order to bring the economy back onto the right track. The formation of a high level finance committee and the establishment of the Malaysian Institute of Corporate Governance (MICG) in year the 1998, the establishment of the Malaysian Code on Corporate Governance (MCCG) in the year 2000, and the establishment of the Minority Shareholders Watchdog Group (MSWG) in the year 2001. To continuously strengthen the structures and practices of CG, the Malaysia government and industry teams, including the Securities Commission, the Companies Commission of Malaysia, Bursa Malaysia Berhad, Bank Negara Malaysia, the Bar Council, the Federation of Public Listed Companies, the Malaysian Institute of Corporate Governance, the Minority Shareholders Watchdog Group, the Malaysian Accounting Standards Board, the Malaysian Institute of Accountants, the Malaysian Institute of Certified Public Accountants, the Institute of Internal Auditors Malaysia, the Malaysian Institute of Chartered Secretaries and Accountants, and the Malaysian Investment Banking Association, revised the MCCG two times which were the MCCG 2000 and MCCG 2007. Currently, CG structure in Malaysia based on new code which is MCCG 2012. In order to restore investor confidence and to attract new capital investment, every organization should have an effective corporate governance structure by fulfilling the requirement and practices suggested by the MCCG. Therefore, the purpose of this study has been to examine the level of corporate governance mechanisms (board matters, nomination matters, audit matters, remuneration matters, communication matters and risk management matters) disclosure of Shari‘ah Compliant companies (ShCCs) in Malaysia.

Literature Review

Definition
The Malaysian High Level Finance Committee defines corporate governance as:

*The process and structure used to direct and manage the business and affairs of the company towards enhancing the business prosperity and corporate accountability with the ultimate objective of realising the long term shareholder value, whilst taking into account the interest of other stakeholders (Securities Commission, 2007:52)*.

The above definition is focused on the board structure and internal control used, and also external aspects such as the relationship with shareholders and stakeholders. Furthermore, Koh (2001) and Sulaiman & Bidin (2002) defined corporate governance as a technique or approach used to direct and manage the organization. Cuervo (2002) found that corporate governance is a mechanism that can be used to control the management and groups of people in the organization, and also to maximize the firm value.

From the above definition, it can be concluded that business prosperity and corporate accountability are very important elements in the CG. Every organization requires an environment of skillfulness, experience, leadership, and teamwork to enhance a business’
prosperity, whilst rules and regulations are needed by the people involved to direct and manage the organization (Arsad, 2002). The ultimate objective that is illustrated from the above definition is to realize long-term shareholders value. This contradicts the ultimate objective from the Islamic perspective that requires every organization to protect the interest and right of shareholders and including other stakeholders (Iqbal & Mirakhor, 2004). In order to help the ShCC to portray the image as an Islamic corporation, CG should play an important role to govern the internal management structure of the company and to ensure that the company’s activities are in line with the Islamic principles and values.

Theories of Corporate Governance
The development of CG has been influenced by varies fields such as finance, economics, accounting, law, management and organizational behavior. The agency theory arose from the fields of finance and economics, whereas the stakeholder theory arose from a social-oriented perspective on corporate governance. There two main theories used in this paper, namely, the stakeholder theory and agency theory.

Stakeholder Theory
The stakeholder theory is defined as “an individual or group of people that can affect or is affected by the achievement of the organization’s objectives” (Freeman, 1984). This illustrates that various stakeholders groups, such as shareholders, employees, creditors, suppliers, customers, government, and local communities, have interest in an organization’s activities. Thus, the stakeholder theory explains to the directors on the board and other management teams that they must conduct their business activities and practices morally and ethically because it will affect the stakeholders’ perceptions towards the organization. Islamic teaching also strongly stresses and emphasizes that business should be conducted ethically, morally, and justly without harm to others. In Surah Ali ‘Imran (3:110) of the Quran, it commands that: “You are the best Ummah brought forth unto mankind. For you enjoin the good works, prohibit the evil and have faith in Allah”

The above verse illustrates that the directors on the board and other management teams in the organization are the best Ummah that have been chosen to give a benefit to other mankind. Therefore, they are required to conduct their business practices in accordance with the Islamic principles and values towards attaining the blessing of Allah s.w.t.; Furthermore, they must disclose information to show their responsibility, accountability, and moral obligation to the stakeholders. Constant support from stakeholders is a very important requirement, so that the organization can maintain or continue the existence of their business (Ullmann, 1985 and Roberts, 1992).

Agency Theory
According to Jensen & Meckling (1976), the agency theory is a contractual relationship between a shareholder and a manager or the top management of the company. The shareholder is the principal or the one that provides capital to the company and engages managers or groups of top management as the agents to perform some services and run the company on behalf of them. The agents have a duty to fulfill their obligations in maximizing the shareholders’ wealth; thus, they will be given by the principal some decision-making authority, a good remuneration
package, and incentives to ensure that all of the agents run their business smoothly and provide the shareholders with information that is related to their business operation.

Even though a lot of authority and rewards have been given, some problems can occur in the agency relationships due to the separate entity between ownership and manager of the company. According to Arnold & de Lange (2004), the agency problems arise when the principal and agents have different attitudes towards risk and interest. For example, some agents not behave according to the best interest of the shareholders, but rather act towards their own self-interest, such as to maximize their compensation, security, status and reputation; whilst shareholders are interested in maximizing return on their investment. The agent and principal problems lead to agency costs, namely, monitoring costs, bonding costs, and residual costs. To reduce agency costs, managers are likely to disclose as much information as possible. Furthermore, board members of a ShCC must always think of themselves as Khalifah (leader) and trustee, and must always promote good deeds all the time and prevent wrong doing in their organization. Since the ShCC must comply with Islamic teachings and principles, their management board should also implement their practices within the Shari’ah rules and Islamic spirit. Members on boards must remember that all possessions, wealth, expertise, abilities, position, and power belongs to Allah s.w.t. and Amanah is entrusted to man. In Surah Ali ‘Imran (3:110) of the Quran, it commands that:

“Allah has purchased the believers’ souls (persons) and their goods for the exchange of paradise”

Being the trustees, agents should not abuse their knowledge or; misuse their power, positions and privileges. They should manage in the best way with the sole intention of creating benefit to the whole ummah (Bardai, 2002). As a result, they can reduce agency problems and costs; whistle it will show that the managers are accountable to shareholders, society and primarily to Allah s.w.t.

Corporate Governance Mechanism

Board Matters

Boards are groups of people who make important decisions about the future direction of organizations and also play a critical role in maximizing the shareholders’ wealth as well as other stakeholders’ interests. Thus, selection of the Board of directors and committee on the basis of their competence is highly required and the board size or number of members on the board has various implications for the board’s functioning (Chaganti, Mahajan, & Sharma, 1985). Islam also emphasizes the important role of the Chief executive officer (CEO) and board members in the organization as khalifah (leader) and trustees of the Earth (Bardai, 2002). In the Islamic business context, leaders, managers or board members must possess certain qualities to enable them to carry out their duties as a “wakil” of Allah (SWT). Therefore, the number of directors on a board that is composed of distinctive qualifications, experience, knowledge, expertise, skills, values, and high education background can be a significant factor influencing the governance of the companies.

In order to lead to better CG, MCCG also suggests having the right balance of executive directors and non-executive (independent) directors in the board’s composition. This is consistent with the agency theory that prefers management to have more independent directors on the boards because it can strengthen the board’s, committee’s and management’s...
effectiveness (Jensen & Meckling, 1976; Fama & Jensen, 1983; Pettigrew & McNulty, 1995 and Mak, 1996).

Nomination Matters
The nomination committee was established to identify, nominate, appoint, and orient new directors. The right talent mix to be a director is a crucial factor in building an effective board. An effective nomination committee should consider the expertise and knowledge of members in the selection of the right talent. Therefore, a board as a whole has the ability to understand the business and contribute to the management of the organization. The nomination committee should also be involved in assessing the existing directors by identifying possible gaps in skills and knowledge that need to be improved or to be filled with the new appointment of directors. This shows that the board nomination committee has sufficient power to exert influence over the nomination and selection of directors. With the absence of a nomination committee on the board, there is a tendency for firms to appoint an unqualified director and fewer independent directors, which can possibly give rise to a conflict of interest. Thus, the presence of a nomination committee has been found to help to resolve agency conflicts and be aligned with the stakeholders’ interests. Since a ShCC must be in line with the Islamic principles, the companies are expected to have directors with Shari'ah backgrounds and Islamic values of accountability and full disclosure concept (Haji & Ghazali, 2013). Cheung, Jiang, & Tan (2010) found that the companies tend to be more transparent in voluntary disclosure when there is a nomination committee on board. O’Sullivan, Percy, & Stewart (2008) examined the association of corporate governance attributes with forward-looking information in the annual report. The result of their study revealed a positive association between nomination committee and voluntary disclosure of forward-looking information.

Audit Matters
Every type of organization face risks, but this is not inherently negative. Identifying and managing the risk appropriately is very important in order to be a sustainable and successful organization in the market. Effective from 1st August 1994, section 334 of the Kuala Lumpur Stock Exchange (KLSE) listing required all public listed companies to establish audit committee. The fundamental duty is to oversee the financial reporting, assess the risk and control environment, evaluate the audit processes, and review conflicts of interest. The establishment of an audit committee is also suggested by the agency theory because it can help to reduce information asymmetry, managerial opportunism, and improve quality of disclosure (Chung, Ho, & Kim, 2004). According to MCCG (2000), the board should establish an audit committee with at least three independent directors or more, have expertise in finance and accounting practices, and be diligent in carrying out their duties. In addition, since the ShCC must be in line with Islamic principles, the companies are expected to have at least one Shari’ah audit to supervise all the activities in the ShCC and to advise the Chief executive officer in the ShCC on the Islamicity of the affairs in the company. Prior research has demonstrated that an audit committee is positively associated with the voluntary disclosure (Ho & Wong, 2001) and (Said, Zainuddin, & Haron, 2009). This implies that, the establishment of an audit committee on board able to enhance an effectiveness of corporate governance in the organization.
Remuneration Matters

The best practices of corporate governance that are stated in the Malaysian code of corporate governance (MCCG, 2007) suggest that the board appoint remuneration committee that consists of wholly or mainly of non-executive directors. In addition, from the commentary to the recommendation 2.3 of the Malaysian code of corporate governance (MCCG, 2012), it specifies that the board should establish a Remuneration committee that consists exclusively or a majority of non-executive directors. As stated in MCCG (2012), remuneration committee is recommends to establish formal and transparent remuneration policies and procedures. The remuneration should reflect the board’s responsibility, expertise, and complexity of the company’s activities. Fair remuneration to the board is very vital to attract, retain, and motivate directors to perform towards stakeholders’ interest. Islam also emphasises fair and good remuneration that can help to derive the best effort from employees including the directors on the board to perform their responsibility (Uddin & Hoque, 2014). Fair and good remuneration must be in accordance the qualification, experience, knowledge, capabilities, and amount of work. Therefore, the presence of a remuneration committee could help to alleviate the conflict of interest between the principal and agent. Moreover, it could also help to ensure that the directors’ actions are aligned with the stakeholders’ interests. As a result, it could help the organization to achieve their predetermined goals and encourage greater corporate disclosure.

Communication Matters

Principle 7 of MCCG (2012) promulgates timely and high quality disclosure. Further, Principles 8 of MCCG (2012) emphasises strengthening the relationship between the company and its shareholders. Every organization is accountable to its shareholders and other stakeholders also. Therefore, board members should take several initiatives to develop the relationship and to show the company’s accountability. Recommendation 7.1 of the code encourages the board members to ensure that the company establishes appropriate corporate disclosure policies and procedures in order to ensure that comprehensive, accurate and timely disclosures of information are provided to shareholders and stakeholders. For effective communication of information, recommendation 7.2 of the code and Paragraph 9.21 of the Listing Requirements encourage the companies to establish corporate websites that can be a platform to facilitate the presentation and communication of information. Moreover, recommendation 8.3 of the Code encourages the board members to promote effective communication and proactive engagement with shareholders through annual general meetings, forums, focus group interviews, meetings with selected representatives of the groups, open discussions on the internet, written communication, etc. The company must be prepared to discuss the issues about economics, social aspects, environment, etc. The principles and recommendations from MCCG (2012) implies that, a high quality disclosure, timely, on-going dialogue, and communication with shareholders as well as stakeholders would help the companies to build trust and understanding in the relationship. Consequently, it helps to increase a good value and image of the companies, specifically ShCCs because communication matters are consistent with the Islamic principles of full disclosure and transparency.
Risk Management Matters

Risk in an organization will appear when there is a weakness existing or the absence of effective control and counter measures within a company’s operating system. Boards are the important group to driving risk governance in the organization. Thus, boards may appoint audit committees or separate committees namely, risk committees to review, manage, and monitor company risks. According to principle 6 of MCCG 2012, a good risk management framework and internal control system should be establish in the organization. Thus, a culture of risk management and integrity should be upheld and must be a part of the board’s decision-making culture. A clear communication about risk management matters should also be channeled to senior management and then down to the operational levels staff. Risk management matters should be extensively communicated to all of the employees in order to ensure that the culture of risk strategy arise in the company. These will help the organization to sharpen their corporate strategy and enhance strategic focus, to free up their capital to be invested in activities, reduce cost, improve the risk finance portfolio, enhance and safeguards the company’s image and reputation, improve regulatory and legal compliances, improves the company’s attractiveness to investors, and identify and establish risk-based control. Collins and Porras (1995) found that organization that manage beyond their stakeholders’ concerns can help the organizations to enhance their risk management ability in the environmental, ethical, reputational, and stakeholder matters.

Methodology

Population and Sample Size

Based on the population of 850 ShCCs for the selected sectors in Malaysia, the sample size of each sector of the ShCC was chosen based on the firms that had maintained their position in the top 500 firms (by market capitalization) for the six-year period from 2008-2013. According to Ahmed Haji & Mohd Ghazali (2013) larger firms tend to have greater visibility and impact on society. The following table illustrates the sampling procedure of this study.

Table 1: Sampling Procedure

| Sampling procedure                                                                 | No. of firms yearly observations |
|------------------------------------------------------------------------------------|----------------------------------|
| Firms that were positioned in the top 500 companies (by market capitalisation) for the six-year period from 2008 to 2013. | 3,000                            |
| Firms that had not maintained their position in the top 500 companies (by market capitalisation) for the six-year period from 2008 to 2013. | 1,190                            |
| Firms that had not completed published Annual Report for the six-year period from 2008 to 2013. | 688                              |
| Final Sample                                                                       | 1,122                            |

1 Corporate Governance Guide 2nd Edition, www.bursamalaysia.com
Process of Constructing the Corporate Governance Index (CGI)

In this paper, the CG mechanism was measured using the content analysis of the annual reports of ShCCs listed in Bursa Malaysia. Therefore, a CG index was employed based on MCCG (2012), the Corporate Governance Guide that was issued by Bursa Malaysia, and Malaysian Corporate Governance (MCG) Index Scorecard (2011) from the Minority Shareholder Watchdog Group (MSWG); (Omar & Rahman, 2009) and (Mohammed, Alwi, & Jamil, 2009). There were six corporate governance matters used, namely, board matters, nomination matters, audit committee matters, remuneration matters, communication matters and risk management matters. A checklist of sixty-three (63) items were used in this study after taking into consideration eight (8) expert opinions, which were from the regulatory board from the Malaysian Institute of Corporate Governance (MICG), internal auditors, academicians, and managing directors of private institutions. The number of items used in this study for the six matters are shown below:

| CG Matters                  | Total Items |
|-----------------------------|-------------|
| Board matters               | 26          |
| Nomination Matters          | 9           |
| Audit Committee Matters     | 12          |
| Remuneration Matters        | 6           |
| Communication Matters       | 6           |
| Risk Management Matters     | 4           |
| Total items for the six matters | 63         |

The weighted method was used to measure the six matters of the CG mechanism, namely, the board matters, nomination matters, audit matters, remuneration matters, and risk management matters. The weighted method incorporated the ordinal values in the index, which commonly had three levels (Beattie, McInnes, & Fearnley, 2004) that were used to assess the single items of the CG mechanism. A number of prior studies have used the weighted method by assigning different values (weights) to the disclosures (Ahmed Haji & Mohd Ghazali, 2013), (Al-Janadi, Rahman, & Haji Omar, 2012). In this study, the CG index was developed using a rating scale of 3; where each item was assigned as zero (0) if the items in the checklist were not disclosed or did not appear in the annual reports, one (1) if the items were disclosed moderately, and two (2) was given to the items that were fully disclosed and followed the MCCG requirements. Lastly, the process added all the scores for each CG matters and they were equally weighted. The scores had been calculated as follows:

\[
CGI_j = \frac{n_j \sum_{t=1} X_{ij}}{N_j \times 2}
\]

Where:
- \( CGI_j \) Corporate Governance Index
- \( N_j \) Number of items expected for the company \( n_j \) item of each dimension
Findings of the Study

Descriptive Statistics

Descriptive statistics through content analysis were used to describe the presence or absence of the 64 CG mechanism items. The descriptive statistics included statistics such as the minimum, maximum, and mean for each of the six CG mechanisms. Table 3 below shows the result of the CG mechanisms, namely, board matters, nomination matters, audit matters, remuneration matters, communication matters, and risk management matters.

Table 3: Descriptive statistics of the Corporate Governance mechanisms

| Variables                      | Min. | Max. | Mean | Std. Deviation |
|-------------------------------|------|------|------|----------------|
| CORPORATE GOVERNANCE MECHANISM |      |      |      |                |
| Board Matters (BM)            | 0.11 | 0.54 | 0.27 | 0.06           |
| Nomination Matters (NM)       | 0.00 | 0.78 | 0.42 | 0.14           |
| Audit Matters (AM)            | 0.17 | 0.71 | 0.49 | 0.06           |
| Remuneration Matters (RM)     | 0.00 | 0.92 | 0.55 | 0.18           |
| Communication Matters (CM)    | 0.00 | 0.83 | 0.46 | 0.20           |
| Risk Management Matters (RK)  | 0.00 | 1.00 | 0.13 | 0.24           |

From the sample of 187 ShCCs from the year 2008 until 2013, the descriptive statistics of the CG mechanisms show that board matters varied from 0.11 to 0.54 with a mean of 27 percent. The results revealed that the board fulfilled the principles and recommendations in the MCCG 2012. For example, the board established clear roles and responsibilities of the board of directors, tenure of the independent director had been reviewed which should not have exceeded a cumulative of nine years, and the majority of the board members were independent directors. However, the mean of the disclosure was only 27 per cent because from the analysis of the CGI, it was found that there were no scores for the item of Shari’ah Advisory Board. From this it can be concluded that, from the sample of 187 ShCCs from year the 2008 until 2013, there were no representatives from the Shari’ah Advisory in the group of board of directors in the companies.

The nomination matters ranged from 0.00 to 0.78 with a mean value of 42 per cent. This result showed that it fulfilled the principle 2 of the MCCG 2012 which is to strengthen the board composition by establishing a nominating committee that is comprised of non-executive directors with the majority being independent, review the criteria to be used in the recruitment, and evaluate the individual performance of the board members.

Audit committee roles are very important to ensure that the financial statements of the company present a true and fair view and are prepared in accordance with the applicable approved accounting standards. Thus, range of audit matters was from 0.17 to 0.71 with a mean of 49 per cent. This was the second highest CG disclosure level and from the analysis, it shows that every selected company had an audit committee on the board.
Remuneration matters had the highest score of the CG disclosure level. The range of the remuneration matters for the six years was constant, which was from 0 to 0.92 with a mean 55 per cent. This was consistent with principle 2 of the strengthening composition in the MCCG 12 that requires the board to establish formal and transparent remuneration policies and procedure in a way to attract and retain directors in the companies.

The range of communication matters was from 0 to 0.83 with a mean value of 46 percent. This showed that it fulfilled principle 7 of the MCCG 2012 which is to ensure timely and high quality disclosure and recommends that the company has appropriate corporate disclosure policies and procedures, and to make use of information technology for effective dissemination of information.

Principle 6 - recognize and manage risks of the MCCG 2012, requires that the board should establish a sound framework and internal audit to manage risks. As a result, the range of risk management matters increased from 0.00 to 1.00. This revealed that the boards fulfilled the principles and recommendations of the MCCG 2012. However, the results of the risk management matters indicates only 13 per cent as the mean value. This was due to a new recommendation, 6.1, from the MCCG 2012 for the companies to focus on risk tolerance and actively identify, assess, and monitor key business risks in order to safeguard the shareholders’ investments and the company’s assets.

Conclusion
The purpose of this paper is to assess and explore the level of disclosure for six CG mechanisms amongst 187 selected ShCCs in Malaysia for the years from 2008 until 2013. From the results, this paper concludes that the highest level of disclosure is remuneration matters (mean: 0.55) and this is followed by audit matters (mean: 0.49). Whilst, the lowest level of disclosure is board matters (mean: 0.13). These values imply that, the ShCCs focused on disclosures that could attract and retain directors in the companies. Secondly, the companies focused on a disclosure that was required by law to have an audit committee to oversee the financial reporting process and to ensure that the financial statements of the company present a true and fair view and are prepared in accordance with the applicable approved accounting standards. On the whole, this paper concludes that the CG reporting of the ShCCs in Malaysia was still at a low level during the years from 2008 until 2013.

According to the chairman of Bursa Malaysia, Tun Mohamed Dzaiddin Hj Abdullah, CG plays a vital role in underpinning the integrity and efficiency of the capital market. Thus, every organization should have effective CG structures that can help the organization to create value, provide accountability, and enable it to attract capital investment. An effective corporate governance structure comes from a strong leadership of the board members in the organization. Therefore, the descriptive statistics in this paper will possibly have several important implications for the enhancement of the CG structure and disclosure of the ShCCs and other organization in many countries because CG is a very significant issue in Malaysia and globally. Firstly, it provides strong evidence to show that the every organization should also focus on other CG matters, such as board matters, nomination matters, communication matters, and risk management matters in order to get a wider acceptance and enhance its reputation. Secondly, the study is expected
to alert the Securities Commission with regards to the definition of Shari’ah compliant status which should also be included in the CG matters about the application of Islamic values and Shari’ah principles in managing their business.

Finally, there are some limitations in this study. This study focused on only the CG mechanisms in ShCCs that had maintained their position in the top 500 firms (by market capitalization) for the year 2008 until 2012. Hence, future research may consider to analysing other companies listed in Bursa Malaysia according to the sector. Future research could also breakdown the analysis of the CG disclosure according to before the enforcement of the MCCG 2012 and after the enforcement of the MCCG 2012.

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