

# **ISLAMIC WORLDVIEW AND EFFECTIVE CORPORATE GOVERNANCE**

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## INTRODUCTION

Corporate governance has become the corporate buzzword since the last two decades (Chapra and Ahmed, 2002). Not until the recent corporate scandals involving gigantic corporations such as Enron, WorldCom, Global Crossing and so forth, the response of corporate entities as well as amongst the public themselves towards the significance of corporate governance are very disappointing. Nevertheless, increasing number of collapses have made public especially investors more aware of the importance to demand high level of corporate governance practices from business entities which they have entrusted their money in them.

The bankruptcy of Enron Corp. has evolved into a scandal of enormous proportions involving allegations of fraud, corruption and unethical practices such as financial manipulation and questionable accounting practices on the part of Enron's corporate executives, members of its board of directors, external auditors and high government officials in the USA (Baker, 2002 and Chatzkel, 2003). The weaknesses in US Generally Accepted Accounting Principles (GAAP) and Financial Accounting Standard Board (FASB) gave enough room to the Enron's management to get an advantage from it by inflating income. Enron had "legally" hide substantial amount of its cost and liabilities into its "special purpose entity (SPE)". The company that uses this practice explicitly has an intention to confuse the public and investors. This is done with the help of its close "business partner", Arthur Andersen that collapse together with Enron. The conflicts between Enron and its auditors are too obvious because the ties between these two gigantic companies went even deeper when Arthur Andersen was not just appointed as an external auditor but also as an internal auditor in the mid-1990s. The auditors had been in conflict to act independently and at this situation auditors have always been in the uncomfortable position of having to judge the financial integrity of the companies that pay them. Arthur Andersen had begun to be a business partner of Enron instead of the auditor that governed by professional ethic.

A more recent case involves Parmalat, an Italian dairy-products group. Parmalat used its subsidiaries to hide the declining in its finance. It has been said that Parmalat was simply created "artificial" assets to offset as much as \$16.2 billion in liabilities and falsified account over a 15 year period and using complex financial transaction to shore up its balance sheet, forcing it into bankruptcy on December 2003 (Edmondson, 2004). Such case was really giving some blows to the international accounting industry.

Meanwhile, Malaysia, the most developing country in the area of South-East Asia also has its very own classical example. Its Malaysian Airlines System (MAS) was the victim in that case. Even though it was managed by the Muslim, it can prevent the company from involving in fraudulent activities. The independence of its auditors, Arthur Andersen was really questionable as it has failed to issue unqualified report for the financial accounts ended 2000 and 2001 although there are indications that the company was having problem with the going concern problem. MAS was under the mountain of debts especially after 1997 due to its high operation costs and related transaction with the company that owned by the directors

at that time. As a consequence, MAS's share prices had dropped significantly. Nevertheless, the government of Malaysia had become the savior of the century by buying back the stake from Naluri Sdn. Bhd at RM8 which was double of current market price. In this case, not only MAS has the problem with its corporate governance, but also the government of Malaysia.

All the above are examples of the failure in the corporate governance. Such failures might result from the failure in the current codes on the corporate governance which is obviously not based on the revelation. At the same, the major player in the system, man should also be blamed due to their greediness. Therefore, in order to resolve this issue one might suggest us to go back to the religious teaching which is in this case, Islam. This paper is trying to describe the contribution of Islamic worldview, which is based on the belief in this universe and the hereafter, to effective corporate governance.

The next section is arranged as follows. Section 2 will deal with the literature review on the corporate governance, covering the definition and its importance. Section 3 focuses on the Islamic worldview and how it can contribute to the *insan muttaqun* (pious individual). Section 4 will be our proposed model for the effective corporate governance. It will among things discuss the issues pertaining to the major components of corporate governance as well as its internal and external forces. The last section will be our conclusion.

## 2.0 CORPORATE GOVERNANCE - AN OVERVIEW

### 2.1 What is Corporate Governance?

Corporate governance is a broad theory concerned with the alignment of management and shareholder interest (Grant, 2003). Governance refers to the way in which something is governed and to the function of governing. According to Cadbury Report (1992);

*“Corporate governance is the system by which companies are directed and controlled”* (p. 4).

A system of corporate governance is needed to ensure that the businesses are running properly (Tricker, 1984)<sup>1</sup> for the realization of the organizational goals (Hemraj, 2002; Bohem, 1995 as quoted in Taylor, 1984). Company needs to be based on guidelines and constraints in achieving its objective such as to maximize wealth of its shareholders and with regard to other groups that have interest in company. Guidelines and constraints including behaving in an ethical way and in compliance with laws and regulation. Here, the concept of accountability sets in (Bacchus, 2003 as quoted in Tricker, 1984).

Normally, responsibility and accountability are heaped onto director's shoulder. Directors are responsible to increase the value of share by enhancing the company performance and in the same time are accountable with the decision that they have made. However, corporate governance is not as simple as what we thought. It is not just referring to the regulation and constraint that need to be complied by company but also concern with how powers are equitably shared and exercised by different groups. Such powers need to be carefully used in the favor of various stakeholders and not merely based on the interests and wills of the power holders. Powers are delegated by investors to company's directors, so that they have a control over the company. Hence, the control mechanisms are emphasizing the enhancement of stakeholders' interest especially to the shareholders who have direct control on the company (Koh, 2001).

Various authors have given different sets of definition regarding corporate governance. Nevertheless, we can conclude here that the essence of the corporate governance is the relationship between management of the company which included the directors, investors, and other interest stakeholders. Good corporate governance can be established if all of these groups can communicate effectively (Grant, 2003) and to achieve this, the conflict of interests need to be reduced among the groups. The major concern of corporate governance is the conflict of interest between the board of directors and other stakeholders groups, especially shareholders and employees. Normally, directors take decisions that are in their personal best interests, and regardless of the interests of other stakeholders. Therefore good corporate governance at least can secure the interest of other stakeholders and directors be more accountable to decision that they take.

Combined Code of Corporate Governance on July 2003 has released Code of Best Practices which is focus on companies' environment and institutional shareholders. An issue that has been given attention is

directors, remuneration, accountability and audit and relation with shareholders (Combined Code of Corporate Governance, 2003).

## **2.2 Why Corporate Governance is important?**

A large company has a large number of stakeholders and has to balance the demand and the need of each and every one of them. Although some stakeholders have a power to influence or decide the action of the company, others who do not have much power need to rely on the information disclosed by company's management which the main source is financial report. This is to ensure that the actions taken by the company are in their interest. Therefore, there are always conflicts between the stakeholder groups. A major concern of corporate governance is to reduce the conflict between directors of the company and other stakeholders especially shareholders and employees as directors normally tend to take decision based on their interest. Furthermore, directors can assess more information therefore in a position to control or manipulate the information that is released to the stakeholders.

*“In the absence of the protections that good governance supplies, asymmetries of information and difficulties of monitoring mean that capital providers who lack control over the corporation will find it risky and costly to protect themselves from the opportunistic behaviour of managers and controlling shareholders” (p. 11)<sup>2</sup>.*

Relationship between board of directors and shareholders is at the center of many problems that arise in corporate governance. Hence, the challenge of good corporate governance is to find a way in which the interest of shareholders, directors and other interest group can all be sufficiently satisfied. Good corporate governance will ensure the company survival for a long time. Directors should somehow or rather be more accountable and responsible to ensure this. They should not think of themselves at the expense of others. Enron is a good example where the directors were rewarded with bonus for almost \$400 million for achieving the target of stock price although they know the company financial was not in a good position. According to Vinten (1998, p. 423), *“companies with chief executives who over pay themselves perform badly in terms of profit and share price; attributes the blame to weak governance and to a lack of alignment between individuals' and shareholders' interest”*.

In order to avoid a conflict of interest that may harm the interest of shareholders and other stakeholders, five issues need to be given high concern which are financial reporting and auditing, director remuneration, decision-making powers, risk taking and a lack of communication between the directors and shareholders.

### **2.2.1 Financial reporting and auditing**

Financial reporting and auditing is one of the main factors in ensuring a good corporate governance. Directors may “make-up” their financial report just to portray better performance of the company. This problem exists because of weaknesses of accounting standards which allow company to do fraud in legal manner. Shenanigans scandal was obvious in Enron and Parmalat. Enron was the biggest accounting scandal ever happened in US

whereas Parmalat representing Europe biggest accounting scandal. Enron had used FASB weaknesses to record its debt and asset for new investment in “special purpose entity” that was allowed to be established. Enron had misstated its earning for more than \$1 billion from year 1997 to 2000. Parmalat was the latest issue and had recorded the largest accounting calamity in the world and history when it involves the losses for more than 13 billion. According to Baker (2002);

*“The sanctioning of off-balance sheet financing vehicles and SPE’s by the FASB and SEC provided the opportunity for Enron to mislead its creditors and investors. Without the tacit involvement of the FAS and the SEC, the Enron scandal could not have occurred”* (p. 463).

Accounting body should tightening its accounting standard in order to avoid the manipulation of accounting numbers although the problems of window dressing are unlikely ever to disappear. Furthermore, the company needs to be forced to produce transparent accounting report and concise descriptions of their accounting policies as well as how it will affect earning and revenue. Indeed, investors have a right to be informed all the relevant information that will affect the future performance as they are the capital provider. Therefore, it is suggested that the company’s annual report must disclose information beyond financial performance. Non-financial information sometime can explain better about the company’s performance and is vital to interpret the quantitative data (Vinten, 2003). Perhaps this may reduce information asymmetry between board of directors and shareholders. In addition, good corporate governance demands good quality of financial reporting which is to be transparent and show the real financial position (Rutteman, 2001).

Increasing in a number of gigantic companies (Enron, WorldCom, Parmalat, Tyco International and Global Crossing) involving in allegations of financial fraud and lack of responsible corporate governance has increased attention on corporate governance in general and the audit committee (internal and external) in particular (Hemraj, 2002, Rezaee et al., 2003 and Weir and Laing, 2001). Audit committee needs to be more transparent in carrying out their auditing job. Scrutiny inspection should be conducted rather than based on sampling because the major weaknesses of sampling process are auditor may over-look fraud sample. According to Vinten (2003), *“all the ramifications of audit independence need to be assessed and reported on as does the detail of how the external audit has been carried out and the conclusion drawn”* (p. 452). In fact, in the current situation in almost countries in the world, audit firm is allowed to do consulting work to the same clients they were auditing which will lead to the conflict of interest (Chatzkel, 2003). Audit firms have involved beyond its traditional areas and their responsibility to produce true and fair view becomes blurred. In this case, the auditor tend to be influenced by client company and they might be persuaded to agree with a controversial method of accounting for particular transactions to show better company’s performance like what Enron had done. The tight regulation needs to be enforced to the audit firm not to do the task that will create a conflict and can affect their independence.



The internal audit and audit committee also need to play significant role to ensure company internal systems are working properly. The major accounting scandals have raised concern regarding the lack of vigilant oversight function of audit committee. Therefore, an effective audit committee reporting can improve corporate governance and accountability to regain the public confidence in financial report (Rezaee et al., 2003). Audit committee should oversee corporate governance, financial report, internal control, internal audit function and external audit service to reduce the risk of company malfeasance. Hence, to effectively fulfill its oversight function, the audit committee should be independent, competent, financially literate, adequately resourced and properly compensated (Rezaee et al., 2003). Audit committee need to build a close working relationship with other participants of corporate governance to achieve its objective.

### **2.2.2 Directors' remuneration**

Independent committee should be formed to determine directors' remuneration. This is important to avoid directors rewarding themselves although company not doing well. At least, remuneration committee can monitor and review the remuneration that should be rewarded to the directors. Reward should depend largely on the performance of the company. It is not fair to give high remuneration to the directors when the company is not performing well as the burden will be heaped to the shareholders by reducing their dividend. Therefore, corporate governance will be the monitoring mechanisms to ensure the shareholders' interest are being promoted (Weir and Laing, 2001). Cadbury Report has delegated the responsibility to the independent directors to monitor the actions of the CEO and other executive directors and to ensure they pursue shareholder interests. However, it is quite difficult for independent directors to monitor an action of the executive directors as they do not involve directly with company management. Indeed, most of them are appointed on a part-time basis. Therefore, they will highly depend on information provided by the executive directors.

### **2.2.3 Decision making-power**

There is a huge debate on to what extent the board of directors exercise their power in the interest of the shareholders and other stakeholders in the company and whether directors' power should be restricted. Corporate governance should effectively monitor the board of directors and this only can be done if the company has proper structure of board of directors. Board of directors structure itself can be a checking system to ensure directors' decision is in line with the company objective. Perhaps, to balance the power within directors, the post of CEO and chairman of the company should be separated (Weir and Lang, 2001). CEO is the most powerful person in the company, therefore, the person in this position is easily making a decision on his own interest. Nevertheless, by having independent chairman, the CEO activities will be examined and any malfeasance can be detected at an earlier stage. Daily and Dalton (1994) as quoted by Weir and Lang (2001) stated that duality is more common to find in failed company than in non-failed company. These two posts ultimately need to be

segregated as it carries different responsibility. CEO is responsibility to the company daily operation and implements corporate strategy, whereas, chairman is responsible to ensure the board of director works effectively. Hence, the role of chairman also involves monitoring and evaluating the performance of executive directors, including the CEO. Combining these two positions onto one person may have negative consequence to the company as the board of directors will lack of monitoring.

#### **2.2.4. Risk management**

Board of directors tends to take a decision to increase profits without giving high attention to the risk faced. Some of the companies are not aware with the changing in risk over the time or when they invested in new project. The obvious example was Enron when it keeps investing in new project without realizes it not giving much return as they expected. At the end, they need to bear a huge amount of losses. Therefore, if there is good corporate governance practiced, the board will be more aware of the risks and shareholder will be more confident on the action of board directors.

#### **2.2.5 Information and communication**

The other issue why company needs to have corporate governance is the lack of communication and information release to the shareholder and stakeholders. The information release normally is based on directors' discretion and the normal information vehicle used by company is annual report. However, the information disclosed is very minimum and just to meet the minimum requirement of regulation. This will increase the information asymmetry gap between management of company and shareholders. Corporate governance set a guide line to enforce the company to disclose beyond the financial position and director's report. Investors have a right to be presented, in a clear and unambiguous way, all the factors that might affects company future performance.

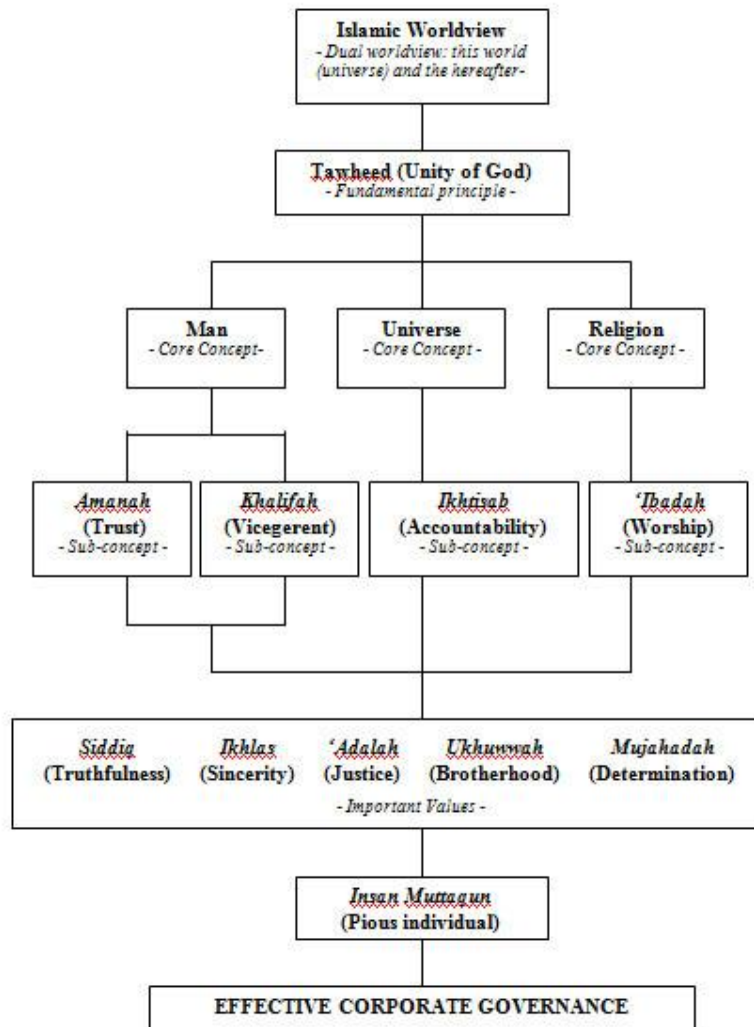
### 3.0 ISLAMIC WORLDVIEW

On a very breezy evening, an old man walking from the north passed by a group of children who were sitting on a wooden bench. The children who were busy talking to themselves did not notice the poor old man. Suddenly, the old man approached them and asked a very simple question, while pointing his forefinger to a big tree: “What do you see?” The first child answered: “It is a tree”. The old man nodded his head. Then, the second child answered: “It is a tree which will die after some times”. The old man smile and nodded his head again to agree with him. Then the last child, after thinking for a while, he opened his mouth and said: “It is a tree. It has been created by the Almighty. The rest of its life has been spent to worship its Creator until one day when the time has come, it will die, leaving this world. Likewise the tree, the same goes to human like us. The only different is that there will be a life after our death where all our actions and deeds in this world will be counted”. The old man was very surprised and tapped the child’s shoulder and said: “Yes, you are true!”

What makes the children gave different answers to the old man? Is it because the third child is more mature than the others? Maybe, but let assume that their level of maturity are the same since they are just children of a same age. One reason for that is what Chapra (1992) called worldview. Worldview is “a set of implicit and explicit assumptions about the origin of the universe and the nature of human life” (p. 1). In other words, worldview is “the way in which a person sees and explains the world and his place in it” (Hamid, 1999, p. 1). As a building with its foundation, worldview serves as an essential base for man since the way he thinks, acts, behaves and his reflections towards everything are directly influenced by his worldview (Hamid, 1999; Chapra, 1992). The different answers provided by the 3 children previously might also as a result of different worldview.

Meanwhile, the sources of worldview might vary. Some acquires it from religions (Hamid, 1999; Baydoun, Mamman and Mohmand, 1999), while others perhaps inherited from their ethnics which they belong to or maybe they just blindly follow others. As compared to the “materialist fundamental secularism” (Shahul, 2001, p. 19) of the Western worldview, Islam sees this world from dual perspectives. In essence, “Islamic ontology presents a dual worldview, this world (universe) and the hereafter” (Shahul, 2001, p. 9). Therefore, how by just looking the world from dual perspectives can contribute to the effective corporate governance? This can be illustrated from the diagram 1.

Shahul (2001) claims that different worldview leads to different values and norms. But before we could derive into various distinguished values, we have to understand that such values are actually originated from different concepts. Based on literatures (Chapra, 1992; Haneef, 1997; Hamid, 1999; Abdalati, 1998), we have identified one fundamental principle, *tawheed*, and three other core concepts, namely man, universe and religion, which are underlying the Islamic worldview.



## **Diagram 1: The function of worldview in shaping corporate governance**

From the fundamental principle and the core concepts, there are several essential sub-concepts, which are *amanah* (trust), *khalifah* (vicegerent), *ikhtisab* (accountability) and *'ibadah* (worship). It is from these core-concepts we derive five significant values which might give far reaching impacts on the corporate governance. The values identified are *siddiq* (truthfulness), *ikhlas* (sincerity), *'adalah* (justice), *ukhuwwah* (brotherhood) and *mujahadah* (determination). If a Muslim has in himself all these values, we do believe that he could become an individual who is really abide by the Islamic teachings and here, we regard him as *insan muttaqun* (pious individual). At the same time, since a major element of any system including corporate governance is people, thus we can conclude that pious individuals can be one of the factors that contribute to the effective corporate governance. A detailed discussion on this, refer section 3.4 of this report.

Now, let us focus on the diagram since the following paragraphs would deal in depth with the fundamental principle, core concepts, sub-concepts and values.

### **3.1 Tawheed (Unity of God)**

*Tawheed* literally means “unification or asserting oneness” (Cowan, 1976 in Bilal, 1994, p. 1). However, here it refers to the realization and maintenance of the Unity and Oneness of Allah in every one’s actions either directly or indirectly. Because of this, *tawheed* or unity of God is not only an important concept but also a fundamental principle for the Islamic faith and it permeates all aspects of life (Haneef, 1997; Alhabshi, 1987). Faith, according to Chapra (1992) is the most important element for human well-being. Apart from putting human relations on a proper foundation, it ensures the realization of other essential values such as equality, brotherhood, social justice, truthful and honesty (Alhabshi, 1987).

The importance of faith in life has been described by Al-Ghazzali as quoted in Chapra (1992). According to him:

*“The very objective of the Shari’ah is to promote the welfare of the people, which lies in safeguarding their faith, their life, their intellect, their posterity and their wealth. Whatever ensures the safeguarding of these five serves public interest and is desirable”* (p. 1).

Faith gives us the light by which we can see what needs to be done and how (Shafaat, 2001). It gives the inner strength to persist patiently and make necessary sacrifices. Above all, it brings the help of God and whatever strength we possess is increased. In addition, it gives us moral and spiritual force that can sometimes conquer without the use of physical force.

Meanwhile, the division of *tawheed* is three (Bilal, 1994), namely *Tawheed ar-Ruboobeeyah* (Maintaining the Unity of Lordship), *Tawheed al-Asmaa was-Sifaat* (Maintaining the Unity of Allah's Names and Attributes) and *Tawheed al-'Ebadah* (Maintaining the Unity of Worship). *Tawheed ar-Ruboobeeyah* means that there is only one God which is Allah, Who caused all things to exist and the only Lord of the universe. This type of *tawheed* is not only accepted by Muslims but also the whole mankind. Meanwhile, *Tawheed al-Asmaa was-Sifaat*, request the creature to have unconditional belief on the 99 Names of Allah as well as His Attributes. This includes the prohibition of adding or repealing any of His Names and Attributes. The utmost important *tawheed*, which distinguishes a Muslim from a non-Muslim, is *Tawheed al-'Ebadah*. Here, it requires all forms of worship must be directed only to Allah because He alone deserves worship and there is no intermediary or intercessor between man and God unlike in any other religions. Thus, if we put the concept of *tawheed* into practice, it will free human beings from their dependence on other human beings. Therefore, to fully appreciate the principle of *tawheed*, one has to accept all the three divisions of *tawheed*.

The very broad effects of this *tawheed* are three (Al-Fawzaan, n.d.):

Uniting the word of Muslims. This will result in strengthening the Muslims and assisting them in defeating their enemies, so long that they continue to follow the Islamic teachings.

Prevalence of safety and peace in a unified society. Since the individuals in such society will take care in doing only that which Allah has made halal and abandoning that which Allah has made haram, it will prevent people from enmity, oppression and injustice, while directing them towards co-operation, love and deep brotherhood for the sake of Allah.

Achievement of happiness, attainment of the khilafah (succession of power and authority) in the earth, maintaining purity of the religion and being steadfast against the onslaught of false belief and foreign ideologies.

As a Muslim, it is important to ensure that we believe that Allah is the ultimate cause and the end of everything. This implies that everything happens in this universe are with Allah's permission. Since He is the only One creator, He deserves all the praise and gratitude. Similarly, every thought and conduct of a Muslim is directed or targeted towards attaining the blessing of Allah S.W.T. *Tawheed* also dictates the relationship between man and his environment. It will prevent mankind from behaving badly and destroying the world in the process. It requires mankind to follow the Message of Allah, thereby avoiding bad and destructive conducts which are detrimental to all living beings on this planet.

## **3.2 The Core Concepts**

As described in the previous paragraph, there are three core concepts which differentiate Islam from the Western, namely the concepts of man, universe and religion.

### **3.2.1 Man**

From an Islamic point of view, human being is created by God in *fitrah*, a state of free from any sin (Hamid, 1999; Al-Faruqi, 1992; Abdalati, 1998;

Chapra, 1992). In another way, all babies born in this world are originally Muslim, submission to the Will and Law of God. Being an innocent creature, man will only be held responsible for his individual actions or inactions in this world. This is because sin is not “hereditary, transferable, or communal in nature” (Abdalati, 1998, p. 58). However, some Westerners (especially Christians) believe in the idea of original sin. This concept implies that the moment a human being comes into this world, he has already inherited in himself the failures and sins of his ancestors (Chapra, 1992).

Unlike any other creatures, men are endowed with *‘aql* (intellectual) so that they can utilize its capacity to manage this world in accordance to the Divine Will (Haneef, 1997; Hamid, 1999). That is why men have been conferred the title of God’s *khalifah* (vicegerent). The word *khalifah* is directly mentioned in the Qur’an, the very first time God intended to create human being;

***“Behold, thy Lord said to the angels: “I will create a vicegerent on earth”. They said: “Will Thou place therein one who will make mischief therein and shed blood? Whilst we do celebrate Thy praises and glorify Thy holy (name)?” He said: “I know what ye know not”” (2:30)***

With the intellectual capabilities, men are given the freedom to choose. According to Shari’ati (1979) as quoted in Triyuwono and Gaffikin (1996);

*“It is only man who can rebel against the way different from that in which he was created, who can defy even his spiritual or bodily needs, and act against the dictates of goodness and virtue...He is free to be good or to be evil, to resemble mud or to resemble God”.*

Hence, we could understand here that the choice of whether to follow the Divine Will or not is made by men. As a consequence, in Islam we have the concept of responsible agent whereby men will be personally responsible for his deeds (Abdalati, 1998). It contradicts with the belief of the Westerners which fall on either of two extremes. The first extreme is called “determinism” or “pawn and tabula rasa” (Chapra, 1992, p. 204). According to this belief, men are “passive agents who is unable to create his social world” (Triyuwono and Gaffikin, 1996). It seems that they are static objects which only respond to the external forces. These external forces have the absolute power and control over the objects. On another extreme which is termed as “Sartre’s existentialism”, it assumes that there is no God and therefore no limit in the freedom enjoy by men. “Every aspect of man’s mental life is intentional, chosen and his responsibility” (Chapra, 1992, p. 205). As this belief only result in the concept of absolute freedom propagated by the capitalist, in Islam, even though men are given freedom, such freedom is not absolute. They are still bound to the Islamic tenets in order to achieve *falah* (success in this life and the hereafter). If men still believe that they are independent and self-sufficient, it will lead them to become extremely proud, ungrateful, and arrogant and as a consequence, they have the tendency to forget or reject the truth of the existence of God (Hamid, 1999). Therefore, the only lifestyle suit with the *khalifah* is humble, down to earth and grateful.

Apart from that, even though men have been regarded as *khalifah*, they actually own nothing of the resources. Only Allah is the ultimate owner of the resources. Men are only trustee of all resources (Al-Faruqi, 1972; Alam, 1998; Baydoun et. al, 1999). This is where the concept of *amanah* (trust) sets in. As a trustee, men have to make sure that they keep the trust according to what has been instructed to them by God. They also have to utilize the resources in an efficient and equitable manner for the benefit of *ummah* (community). Allah has mentioned in the Qur'an;

***“O ye who believe! Betray not the trust of God and Apostles, nor misappropriate knowingly things entrusted to you” (8:27)***

Thus, the concepts of *khalifah* and *amanah* absolutely have implications in everyday lives of a human. If men really understand both concepts, they will be no corruption in this world. The same things will be for corporate governance. The concept of *khalifah* entails that one has to manage this world according to the Divine Will. Meanwhile, realizing the resources owned by a company are actually entrusted by other people i.e. shareholders, depositors etc. this will require those who manage the company to be *amanah*.

### 3.2.2 Universe

Westerners who are claimed by Shahul (2001, p. 19) uphold the “materialist fundamental secularism” most of them disbelieve in the existence of life after death. Such a belief renders them to devote their life totally to the achievement in this world. Due to that, the most successful man according to them is the one with the most material achievement.

On the other hand, in Islam besides this world we believe in the existence of the eternal life after death. Happiness in that life depends on our deeds in this world. If we fill our life in this world with good deeds, instead of the bad ones, it will at least grant us with the happiness in the eternal life. This temporary world is full of tests and trials (Chapra, 1992) which determine whether one deserves to be in the Heaven or otherwise to be dumped in the Hell fire. Even though our aim is to achieve happiness in the hereafter, Islam never requires us to abandon everything that relates to this world;

***“But seek, with the (wealth) which God has bestowed on thee, the Home of the Hereafter, nor forget thy portion in this world; but do thou good, as God has been good to thee, and seek not (occasions for) mischief in the land: for God loves not those who do mischief” (28:77).***

Believing in the existence of the *ghai'bat* (invisible world) such as Heaven, Hell, Evil, etc is another way of perceiving this world which some of the Westerners refused to accept it. The existence of two angels with every human being who records their every act and this record of reward and sin should force us to behave according to the Divine Will.

By having faith in the rewards and punishments (Shahul, 2001), the concept of accountability plays a major role. As a Muslim, we should believe that we will be held accountable to whatever we did during our life. Not only our actions will be taken into consideration, but rather more importantly is our intention. Therefore, we have to be really sure that we do not deviate from the Islamic values and norms.



### 3.2.3 Religion

Religion from a Western viewpoint is:

*“a way of spending an hour or so on Sundays in practices...It has little or nothing to do with commerce or economics or politics or industrial relationship”* (Haneef, 1997, p. 40).

From this statement, we clearly understand that Western separates the religion from their worldly activities. It means that religion is only a private matter. Even worse than that, some of them may only turn to religion especially in times of distress (Hamid, 1999).

On the other hand, the Unity of God implies that there is no separation between religion and material life. The Islamic religion regulates every aspect of life of its followers, including politics, economics, social and so on. Therefore, the separation between religion and the management of the affairs of organization is not accepted in Islam (Baydoun et. al, 1999). This also means that there is no separation between economic responsibility and ethical responsibility from Islamic standpoint.

In addition, Islam is not merely a religion but it is a complete way of life (Alam, 1998; Alhabshi, 1987). The term “way of life” is actually extracted from the Arabic word *din*. According to Muratta and Chittick (1996), literally *din* means “to obey, to be submissive and to serve” (p. xxviii). From a different context, it also refers to *dayn*, which means debt. As an analogy, if you have a debt, definitely you have to pay to the lender. Same goes to the relationship between man and God. God has given everything to be enjoyed by man. As a result, man becomes indebted to God and therefore need to pay back as a sign of gratitude. Since God gives us life, thus everything we do in this life (totally) must please God.

Apart from being regarded as *khalifah*, men have to realize that they are also ‘*abd* (servant) to Allah. Allah has stated in the Qur’an,

***“I have created Jinns and men, that they may serve Me” (51:50)***

From this *Qur’anic* verse, we understand that the purpose of our existence in this world is to worship Allah. Since, Islam is the way of life, the concept of ‘*ibadah* is very relevant here. It also reflects the requirement of *tawheed al-‘ibadah* as described previously where an ‘*abd* must make sure that he only worship the One and only, Allah. However, before an action can be considered as an ‘*ibadah*, one needs to have good intention and that action must not contradict with the Islamic tenets.

Since westerners believe that religion is a private matter and relates to Church, therefore they only act and behave morally in Church. When they leave Church, their life has been freed from any religious constraints. However, in Islam, be it is in the mosque, in the public places or even in the toilet, Muslims must submit themselves to God and behave accordingly to the Islamic teachings. They must make sure that everything they do are regarded as ‘*ibadah* by Allah so that they can increase their chances of getting *jannah* (heaven).

In order for men to discharge their responsibilities as an ‘*abd*, Allah has provided them with the Holy *Qur’an*. Holy Qur’an provides the answer to that all important questions by imparting sure and complete guidance in all different problems of human life, including ethics (Ansari, 2001). Apart

from that, Allah has sent us the Prophet in which all the good examples can be found;

***“Ye have indeed in the Apostle of God a beautiful pattern (of conduct) for any one whose hope is in God and the Final Day, and who engages much in the praise of God” (33:21)***

It is this verse, as a Muslim, we should make the Prophet as our role model in our daily lives. Unfortunately, Muslims nowadays have been corrupted by the Western ideologies to the extent that their role models are celebrities, sportsmen, politician etc which have lifestyle most of the time deviates from the *shari’ah* guidelines. Thus, to succeed in this life and the hereafter, we should follow the guidelines of the *Qur’an* and the Prophets in each and every part of our life and not merely in the case of getting married or more than one wife!

### 3.3 Important Values

From the concepts we derive five important values, namely *siddiq*, *ikhlas*, *adalah*, *ukhuwwah* and *mujahadah*.

#### 3.3.1 Siddiq (Truthfulness)

Truthfulness is a basic ethical value of Islam. It has been stated in the Qur’an;

***“O ye who believe! Fear God, and (always) say a word directed to the Right” (33:70)***

The truthful people are those who do not lie in their sayings or their promises. In fact, our Prophet, Muhammad (pbuh) is the most truthful person and regarded as *as-Sadiq*. However, the concept of truthfulness is actually wider than just in sayings. One also needs to be truthful in action and more importantly in faith. Truthfulness in faith can only be achieved when there is congruence between intentions, words and actions.

Maududi (1992) as quoted in Raba (2001) defined the meaning of *siddiq*:

***“The one who is upright and just, who is always actuated by truth and righteousness; who is fair and equitable in all his dealings; who always sides with truth and justice from the core of his heart; who opposes tooth and nail all that is unfair; without showing the least weakness; who is pure and so unselfish that both friends and foes expect nothing but impartially from him” (p. 179).***

The importance of truthfulness is described here to the extent that it covers all other values such as righteousness, trustworthiness, justice, fairness and brotherhood. That is why in a different verse in the Qur’an, Allah did rank truthful individuals in the second group after the Prophets;

***“All who obey God and the apostle are in the company of those on whom is the Grace of God, - of the prophets (who teach), the sincere (lovers of Truth), the witnesses (who testify), and the Righteous (who do good): Ah! What a beautiful fellowship!” (4:69)***

Thus, in the context of corporate governance, a business has to be honest, truthful and straightforward in all of his business dealing (Elati, n. d.). Later on, we will look that an important element of corporate governance in Islamic institutions is the *Shari’ah* Supervisory Board (SSB) which is responsible to ensure that all activities have been carried out in accordance

to *Shari'ah*. People will rely on the report issued by the SSB in the annual report to evaluate the conformance with the *Shari'ah*. Without this truthfulness, definitely the objective of the report can be achieved.

### 3.3.2 *Ikhlas* (Sincerity)

Another important value in Islam is *ikhlas* (sincerity). This value is actually determining whether one's deeds can be considered as *'ibadah*. The importance of *ikhlas* is obviously described in Islam to the extent that the *hadith* (Prophet's sayings) regarding of *niyyah* (intention) is placed first in the collection of *hadiths* by Imam Nawawi;

*"Actions are to be judged only by intentions"*

Al-Ghazzali interprets this by saying that;

*"Intention, without action is superior to action without intention, since action without intention is not worship, though intention without action is worship"* (Umaruddin, 2003, p. 261).

According to the concept of *'ibadah* previously discussed, we have understood that the sole purpose of man creation is to worship God. Therefore, to ensure that everything we do is considered by *'ibadah*, our intention must be solely directed to get Allah's pleasure. Nevertheless, most of us misunderstood the relationship between intention and action. Both our intention and action must be good in order to consider *'ibadah*. It is totally different from the ends-means ethic practiced by the Westerners.

In the context of corporate governance, managing a company, be it a small or big company, as long as the management is based on the Islamic teachings, therefore it can constitute an *'ibadah*. If one is sincere, he surely will try his best to manage the company in a way that it can benefit not only the shareholders or owners of the company, but the fruits are also enjoyed by the whole *ummah* (community). Especially in the case of Islamic institutions whereby they are required to pay *zakah*, they pay in sincere, without any attempt to plan the *zakah* payment or other intentions such as to reduce tax payment.

### 3.3.3 'Adalah (Justice)

Establishment of justice is very essential in Islam and became the primary mission of all God's Messengers:

***"We sent aforetime our apostles with clear Signs and sent down with them the Book and the Balance (of Right and Wrong), then men may stand forth in justice;" (57:25).***

Justice means that "everything should be placed in its proper place" (Umaruddin, 2003, p. 204). Al-Ghazzali even regards justice as one of the four cardinal virtues together with wisdom, courage and temperance. In addition, it is also one of the principal aims of *Shari'ah* (Alhabshi, 1987; Chapra, 1992)

However, the establishment of justice is not possible unless if it is based on *tawheed* (Alhabshi, 1987). This is because *tawheed* implies that it is either one between two: the Creator and created. Since there is only one Creator which is Allah, therefore all others are creatures. In the case of human being, all men are equal and thus there is no such thing as one is superior than others to the extent that he must be worshipped.

In the case of business, justice plays a very important role to prevent discriminations and excessive monopolies while at the same time ensure fair treatment and equitable distribution of wealth (Elati, n.d.). Equitable distribution here means that every individual will have its own right to income and wealth depending on the person's intelligence, ability, aptitude, expertise and wisdom. Fair treatment implies that a company might have different types of stakeholders, from the shareholders to the community at large, where each has its own needs and rights. In order to practice social justice, management of the company has to take into consideration the needs of these various stakeholders and try their best in fulfilling it. Failure to do so will result in numbers of problems such as fraud, insider trading, strike and other social and environmental consequences.

### 3.3.4 Ukhuwwah (Brotherhood)

Similar to the concept of justice, *ukhuwwah* (brotherhood) is actually a bond that ties one man to another. This concept of one brotherhood keeps all individual at the same level regardless of race, colors, language etc. It is the fundamental principle in understanding the sense of community (*ummah*), fraternity and associativeness (Bashir, 1998). Since all men are equal, therefore one should not have negative perception and intention towards other people. They should sincerely take care and love of others since the Prophet (pbuh) is said to have mentioned:

*“Abu Hamzah Anas bin Malik r.a. who was servant of the Messenger of Allah (pbuh) reported that the Prophet (pbuh), said:*

*None of you truly believes (in Allah and in His religion) until he loves for his brother what he loves for himself (Al-Bukhari & Muslims)”.*<sup>3</sup>

Al-Ghazzali in Umaruddin (2003) claims that the highest form of friendship in Islam is when the needs of a brother is preferred or prioritized over one's own needs. Even though this type of friendship is easier said than done especially in today's world where material becomes the aim, if it can be practiced, nobody will feel depressed, unfairly treated and consequently the spirit of cooperation can be collectively flourished.

The *Qur'anic* model code is based on the emphasis on 'duty' in contrast to the emphasis on 'right' (Ansari, 2001). Right is against someone, whereas duty is a duty towards someone. The emphasis on duties creates harmony in social life, because if everyone were to concentrate on his or her duty, the emphasis on grumbling for rights naturally vanish. On the contrary, the emphasis on rights creates strife because if everyone were to think about his rights on others, he would hardly have the mind to think of his duties towards others. This is actually the essence of brotherhood in Islam.

*Ukhuwwah*, apart from can tighten the relationship among people, it also can hinder individualism. Individualists will only think about maximizing their own benefit to the extent that such achievement might be attained at the expense of others. In the context of corporate governance, *ukhuwwah* among the members of the organization is rather more essential to ensure that day-to-day operation can run smoothly. It is from this spirit, one feels obliged to take care of others. For instance, let say a manager has been found unintentionally taking his work for granted. Realizing that it will harm the whole company as well as other stakeholders, a responsible

colleague feels responsible to remind him on his attitude. Without the spirit of brotherhood, perhaps that colleague might just ignore and let the manager to continuously do the mistake. At the same time, he is counting days to report such wrongdoing to a higher level manager so that the manager can be sacked from the organization.

### 3.3.5 Mujahadah (Determination)

*Mujahadah* (determination) is very important an act as a complementary value to ensure the fulfillment of other values. According to Al-Ghazzali in Umaruddin (2003), *mujahadah* “must be resorted to in order to renounce worldly things” (p. 258). One’s strength in overcoming the evil and other negative influences is determined by how deep his faith to Allah. Therefore, even though *mujahadah* against the self is extremely difficult, it is most indispensable means to spiritual progress. Because of the difficulties in struggling against the self, some *Sufis* regard it as greater *jihad* than fighting against the enemies (Umaruddin, 2003)

Raba (2001) claims that there are few characteristics of self have been mentioned in the Qur’an, namely *Al-Nafs Al-Ammarah* (The Commanding Nafs), *Al-Nafs Al-Llawwamah* (The Accusatory Nafs), and *Al-Nafs Al-Mutmainnah* (The Perfected Nafs). Of course, one should strive hard to get the *Al-Nafs Al-Mutmainnah*. By maintaining such self, it will influence us to do good deeds and at the same time, good values such as truthfulness, sincerity, justice and brotherhood can easily be ingrained in ourselves. On the contrary, if one maintains with the *Al-Nafs Al-Ammarah*, he is prone to do bad things.

However, one has to really strive very hard to achieve the level of *Al-Nafs Al-Mutmainnah*. He not only has to keep his heart “clean” but also needs to constantly perform *muhasabah* (self-examination). Such *muhasabah*, if it is done sincerely, should be able to help him to be a better individual not only spiritually but also in every spheres of life.

### 3.4 Insan Muttaqun (Pious Individual)

Allah has stated in the *Qur’an* of those people who occupy the highest level of man;

***“O mankind! We created you from a single (pair) of a male and a female, and made you into nations and tribes, that ye may know each other (not that ye may despise each other). Verily the most honored of you in the sight of God is (he who is) the most righteous of you.” (49:13)***

As mentioned previously, we have agreed that people is the most essential element in any system. Such contention is agreed by Abod (2002) whereby he claims that:

*“It is man who is involved in the process of managing the business of the company towards achieving its mainstream goal of maximizing the wealth of its owners (the shareholders). The codes of upholding trust, maintaining integrity, exercising transparency and accountability ...would remain as mere noble codes if the issues of man, his values, ethics and moral conduct are not tackled in the first instance” (p. 100)*

Man does change his characters and behaviors in different places, time and situations even in a constant economic scenario. The changes are very

much influenced by his feelings, moods, prejudices and value system (Alhabshi, 1987). Thus, *tawheed* is the only consistent and suitable principle that will direct human beings to search for the blessing of Allah S.W.T.

All in all, *tawheed* is the root of ethics and high morals. From *tawheed* will emerge elements such as truthfulness, sincerity, justice, brotherhood and determination. *Tawheed* will therefore prevent and eliminate all activities that are forbidden in Islam. Thus, if everyone have such a *tawheedic* worldview, it will at least one factor that can lead to the effective corporate governance.

## **4.0 DEVELOPMENT OF A MODEL OF EFFECTIVE CORPORATE GOVERNANCE**

Our model constitutes 4 integrated layers of the corporate governance (see Diagram 2). The most inner layer represents the organizational environment. As a matter of fact, there are 5 major components of the corporate governance. These 5 components are *Shari'ah* Supervisory Board (SSB), Board of Directors (BOD), Management, Internal *Shari'ah* Audit (ISA) and Internal Audit (IA). What makes them to function effectively are internal forces which include the internal control and procedures, *shari'ah* infused values individuals, human resource development and *shuratic* decision making. The next layer represents all the significant external forces that are responsible to determine the 'rules of the game'. On one extreme, the company needs to meet the expectations of the various stakeholders, and on another extreme, there are sets of legal rules and regulations that need to be abided by the company. However, the rules and regulations must be designed in such a way that they are in line with the *Shar'iah* requirements. It also means that the *maqasid* of *shari'ah* must be the utmost important criteria in deriving such rules and regulations. Meanwhile, the most outer layer represents the Islamic worldview which becomes the foundation of the effective corporate governance.

### **4.1 Components of the Islamic Corporate Governance**

#### **4.1.1 Shari'ah Supervisory Board (SSB)**

Suleiman (n.d.) claims that:

*“Islamic banks (or organizations) have a major responsibility to shoulder...all the staff of such banks and customers dealing with them must be reformed Islamically and act within the framework of an Islamic formula, so that any person approaching an Islamic bank should be given the impression that he is entering a sacred place to perform a religious ritual, that is the use and employment of capital for what is acceptable and satisfactory to God”* (p. 101)

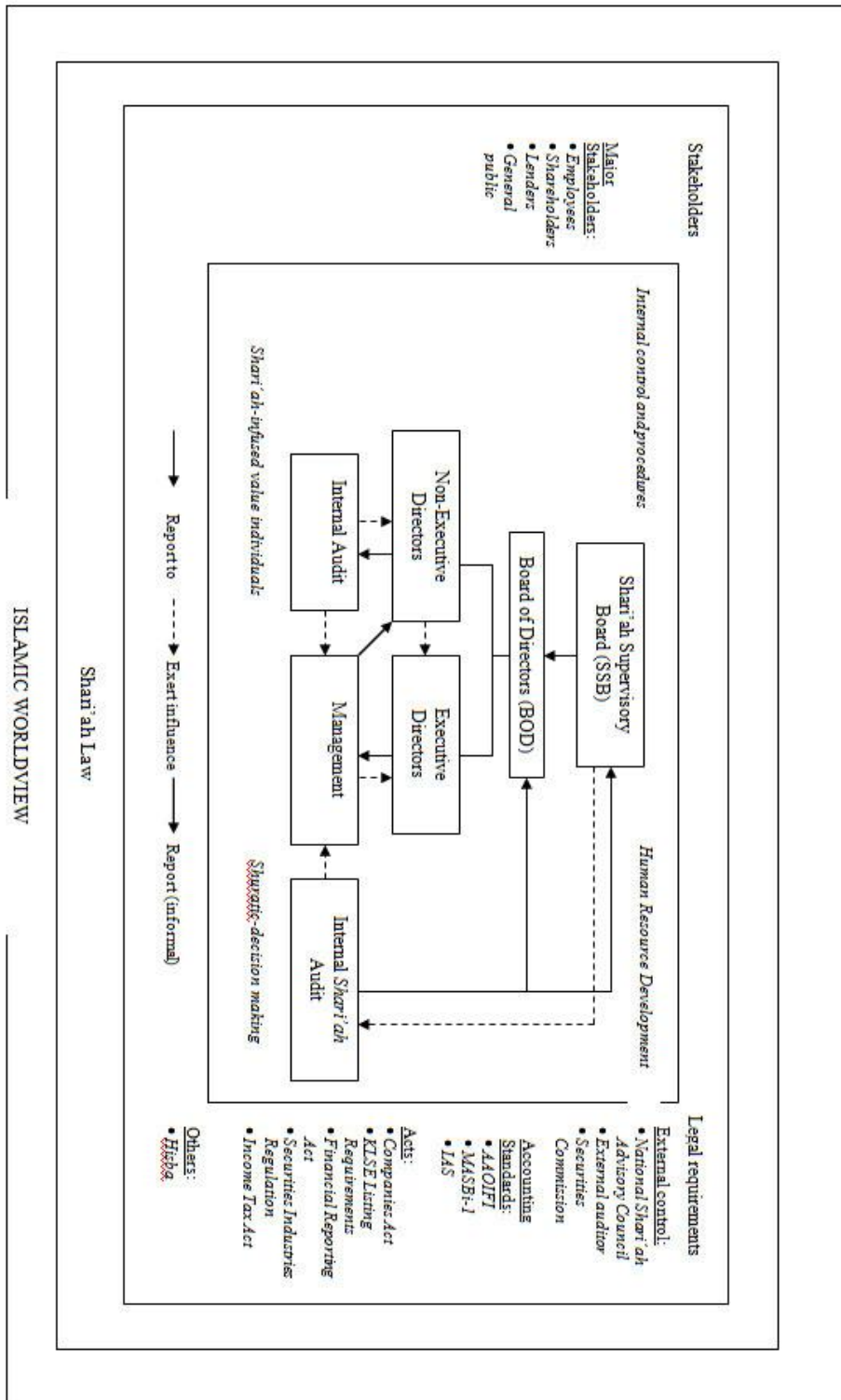
This quotation means that Islamic organizations should meet the high expectations of the public especially those who really concern with how Islamic the Islamic organizations. Such expectation leads to a two-tier governance system which consists of the SSB and BOD.

Unfortunately, the current function of the SSB is just to give advice on matters pertaining to products. By right, their functions are wider and include careful scrutinizing of the whole activities of the organization to ensure that they do not contravene the *Shari'ah* teachings. At the end of the accounting period, they need to issue a report to be reported to the shareholders regarding the compliance of the organization on the *shari'ah* requirements. The report should contain among other things, review on the principles and contracts relating to the transactions and applications introduced by the Islamic Financial Institution; opinion regarding its compliance with *Shari'ah* Rules and Principles, specific *fatwas*, rulings and other guidelines; procedures involved in the review process; and the allocation of profit, realization of earnings as well as the calculation of

*zakah* (Governance Standard for Islamic Financial Institutions No. 1, AAOIFI).

Another issue that might be raised here is regarding the independence of the SSB members. Even though physically, the SSB looks independent, the fact that they are appointed by the BOD and subsequently they are paid for their services, the issue of ‘independence of mind’ might need to be taken care of. Since the employer-employee relationship might occur here, there are tendencies that the SSB is tied to the BOD’s instructions.





**Diagram 2: A model for an effective corporate governance**

Nevertheless, as an individual who might have certain level of interests towards this issue, should bear in mind that their job is not only to criticize and be prejudice. Instead, they should have trusted (*husnu az- dzan*) the SSB in discharging their duties. If not us, who else will believe them? In addition, according to Karim (n.d.), the employee relationship does not seem to generate significant doubts about the SSB members' independence. In fact, their independence tends to stem from deep commitment to Islamic precepts.

In terms of authoritativeness in an organization, SSB is expected to have influence in the BOD, which is the highest authority in a normal organization. This influence is actually reflecting to the SSB's capacity in giving advice to the BOD in whatever matters pertaining to Islamic conducts, not only in terms of product but also covers the entire operation. To assist the SSB in examining the extent of the compliance of the organization's activities to the Islamic requirements, there should be an internal *shari'ah* audit (ISA).

#### **4.1.2 Board of Directors (BOD)**

In terms of structure, the BOD should be composed by both executive and non-executive directors. While the majority of the members should be non-executives, some of the Codes on the Corporate Governance emphasize the importance of having independent non-executive directors i.e. Brazilian Institute of Corporate Governance Code of Best Practices (BICGGCBP), Malaysian Code on Corporate Governance (MCCG), Combined Code on Corporate Governance (CCCG) and Code of Best Practices for Corporate Governance in Islamic Financial Institutions (CBPCGIFI). What is meant by the term 'independence' as according to BICGGCBP is;

*"a director is independent if he or she: has no link to the company besides board membership and share ownership and receives no compensation from the company other than director remuneration or shareholder dividends; has never been an employee of the company (or of an affiliate or subsidiary); provides no services or products to the company (and is not employed by a firm providing major services or products); and is not a close relative of any officer, manager or controlling shareholder"* (Gregory and Simms, 1999, p. 17)

In addition to that, there is a need of majority of the BOD to be non-executive. This is to monitor the effectiveness of the non-executive in steering the company. Such monitoring will ensure that the actions taken by these executive directors are in line with the interests of the company and not of themselves. That is why the function of the non-executive directors becomes more important rather than attending 'paid' meetings without really concern what is going out in the company. This is what we called 'sleeping directors'.

Most literatures have focused on the issue of the independence of the members of the BOD. As a matter of fact, these board members are appointed by the major shareholders. This will result in those who have not even own shares in a company, might be appointed as a director. Since he is appointed by the major shareholders, there is a tendency that this director

will make decision that will satisfy the needs of majority shareholders and this might be at the expense of minority shareholders.

In addition, most appointment is based on ‘worldly’ criteria such as academic qualification, working experience, competency etc. At the same time, the more ‘spiritual’ criteria such as the moral attitude, ethical behavior and religious commitment of an individual have been sidelined. Thus, there should be a balance between the ‘worldly’ and ‘spiritual’ criteria in the appointment so as to ensure that the future decisions and actions he will undertake are ethically and professionally-based.

BOD, be it executives or non-executives, should refer to the SSB in their decisions. This is to ensure that they strictly follow the Islamic tenets. Meanwhile, the nature of audit requires it to be headed by the non-executive directors. Therefore, the executive directors should not have any influence to the internal audit function. However, the executive directors are responsible to monitor the day-to-day operations of the company.

#### 4.1.3 Management

Management here refers to the senior-level managers. They are the ones who execute the directives from the BOD and able to delegate works to the lower-level employees. As a matter of fact, they are more knowledgeable in terms of the company’s operations.

The management should be expected to act as a bridge between the directors and the employees. Any suggestions or dissatisfaction should be channeled accordingly in order to promote a harmony working environment. Sometimes, there is a conflict between the BOD and management. For instance, unethical board members might instruct the managers to do malpractice. Management, realizing the fact that they are salaried by the company, therefore they feel obliged to fulfill the directions in order to secure their positions.

However, in the *Qur’an*, it is clearly stated that other than Allah and His Prophet, the loyalty to others are so long the instructions do not contravene with the *shari’ah* requirements;

***“Obey God, and obey the Apostle, and those charged with authority among you. If ye differ in anything among yourselves, refer it to God and His Apostle, if ye believe in God and the Last Day: That’s the best, and most suitable for final determination” (4:59).***

In this verse, it is clearly stated that the absolute loyalty is towards Allah and His Apostle whereas the loyalty to other than that depending on certain circumstances. This is reflected in the *tawheedic* worldview that we are talking about whereby men should not be dependent on other men. However, such principle is always forgotten by Muslims nowadays that lead them to blindly follow other persons’ instructions which cause them to get involved in fraudulent activities.

In current practice, if such situation happens management has ‘no shoulder to cry on’. In facing this ethical dilemma, they have only one of two options: whether to follow the instructions or to resign. Therefore, we suggest that the gap between the non-executive directors and management should be bridged. In order to achieve this, the non-executive directors should have frequent communication and work closely with the

management. As a result, the management will feel more comfortable to report any unethical instructions from the executive directors. Since the non-executive directors have the privilege to monitor the actions of executive directors, they can properly solve these issues.

On the contrary, if the fraud or malpractice is initiated by the management themselves, there should be an internal audit (IA) and a *Shari'ah* Internal Audit (SIA) to act as effective 'watchdogs'. Both units will ensure that management has strictly followed the prescribed procedures and has not attempted to contravene the internal controls.

#### **4.1.4 Internal Audit (IA) and Internal Shari'ah Audit (ISA)**

Internal Audit (IA) functions to ensure that all internal control systems are in place and the management has followed the procedures stated therein. Any reports on findings should be addressed to the audit committee. While IA focuses more on the financial and operational aspect, Internal *Shar'iah* Audit will focus more on the *shari'ah* compliance of the organizational activities. Since IA is a normal phenomenon in the current practice, the following paragraphs will only deal with the ISA.

Internal *Shari'ah* Audit (ISA) is another control mechanism that needs to be established especially in Islamic Institutions. As compared to the conventional auditors who are governed by legal rules and professional codes of ethics, religious auditors are guided by their moral beliefs and obligations to religious peers and the community (Rahim, 1998). The need to have an ISA is very important especially in the current times where those who are well-versed in the *shari'ah* are not necessarily knowledgeable about the present state of affairs in banking, finance and accounting. Similarly, those who are versed in the latter are not necessarily knowledgeable in the *shari'ah*. Here, we can conclude that the ISA should assist the SSB in ensuring that the company has strictly followed the *shari'ah* requirements.

Briston and El-Ashker (1986) in Rahim (1998) clarifies that there are 3 functions of Islamic religious auditing, namely ex-ante auditing, ex-post auditing and the audit of Islamic tax. Ex-ante auditing refers to the advising the BOD and managing director, contracts and procedures to ensure that all are in conformity with the Islamic code. While this function is more relevant to the SSB, the other two are mostly related to the ISA. Ex-post auditing checks whether the executive management has complied with all the Islamic principles and with the advice which the SSB has given. Meanwhile, the audit of Islamic tax or *zakah* fund is necessary to ensure that *zakah* on the enterprise's net assets is properly calculated and the fund is properly administered.

AAOIFI in its Governance Standard for Islamic Financial Institutions No. 3 has listed 4 functions of the internal *shari'ah* review, namely:

- Planning review procedures,**
- Executing review procedures and preparation and review of working papers,**
- Performing follow-up, and**
- Documenting conclusion and report**

Under the planning review procedures, ISA should among other things, obtain background information about the activities to be reviewed, establish

objectives and scope of work, obtain SSB *fatwas*, guidelines, prior year's reports, and also determine the resources necessary to perform the internal *shari'ah* review. Next, the ISA shall collect, analyze, interpret and document information to support their internal *shari'ah* review results. Working papers that document the review shall be prepared, completed and organized so that it can be reviewed by the Head of ISA. While performing their tasks, ISA should make regular follow-up in any findings.

The Head of ISA should discuss with the management regarding the audit review before final report can be written. Even though he needs to consult with the management, it does not mean that the management can simply have influence on the report. Instead, it is a kind of formal procedures in respecting the management as the highest level of executives in a company. Then, final report will be submitted to the BOD and SSB.

What kind of ethics that will govern both the auditors in performing their works? AAOIFI has listed 6 principles of ethics as outlined in its Code of Ethics for Accountants and Auditors of Islamic Financial Institutions. As an auditor, he/she must uphold the principles of trustworthiness, legitimacy, objectivity, professional competence and diligence, faith-driven conduct, professional conduct and technical standards.

## **4.2 Internal Forces**

### **4.2.1 Internal Control and Procedures**

The existence of an effective controls system is important for the safety and soundness of all organizations (Chapra and Ahmed, 2002). It can help the realization of organizational goals and achievement of the long term profitability. Experience has shown that the existence of effective internal controls could help prevented or enabled early detection of, many fraudulent activities from occurring. Nevertheless, by only having internal controls system is insufficient since what is more important is the on-going monitoring and examining the systems to ensure compliance with rules and procedures, exposure limits, approvals and authorizations and verification and reconciliation. Thus, critical elements such as the internal audit system must be adequately independent.

Most of the codes on corporate governances are voluntary in nature. It is up to the management of the company whether to follow it or not. However, in Malaysia, by virtue of Paragraph 15.26 of the KLSE Listing Requirements,

*"...all listed companies should state in their annual report how they have applied the principles set out in Part 1 of the Code and the extent to which they have complied with the best practices set out in Part 2 and identify and give reasons for any areas of non-compliance, and where applicable, state the alternative practice(s) adopted"* (Paragraph 4.1, MCGG, 2000, p. 6).

Therefore, Hamid (2002) suggested that the code on corporate governance to be treated as a part of the ISO standards. It does not only documenting all the procedures that need to be followed but, as a matter of fact, the adoption of the ISO standards, "would subject the company to all kinds of scrutiny such as the surveillance audit and so on" (p. 120). Thus, by having such standards, the external auditor has to conduct a so-called

management audit to ensure that all procedures as documented have been strictly followed.

Performance measurement is another aspect that needs a critical attention. A system without measurement is incomplete and useless. Therefore, a company at the end of the day needs to measure the effectiveness of its governance system. One way to measure such performance is through developing an index. Adewirman, Alrazi, Mohd. Nor and Pramono (2003) has developed an index to measure the performance of Islamic banking, One of the components of such *Islamicity* index is corporate governance indicator. The indicator is based on the list of items that should be disclosed in the annual report (Refer Appendix 1). Since it is only based on the disclosure, a company might need to have a more comprehensive indicator of governance performance.

#### 4.2.2 Shuratic Decision Making

The institution of *shura* or rather *shuratic* decision making is another factor that can lead to the achievement of effective corporate governance. The importance of making decision based on *shura* (consensus) is stated in the Qur'an;

***“Those who hearken to their Lord, and establish regular prayer, who (conduct) their affairs by mutual Consultation; who spend out of what We bestow on them for Sustenance” (42:38)***

Besides, according to Sulaiman (1999), *shura* constitutes one of the four cardinal principles in the Islamic perspective on socio-political organization. The other three are justice, equality and human dignity. *Shura* is predicated on three basic percepts. First and foremost, all men are equal in human and civil rights. Secondly, the issues pertaining to the public interest are best decided by majority view. Besides, the three other values namely justice, equality and human dignity are best realized, be it in the personal or public life, under the *shura* governance. Even though it seems that the *shura* we are talking about is quite parallel with the democracy propagated by the Western, there are basically three distinguished characteristics between them. Firstly, the decision made under *shura* is based on the serious consideration of Islamic tenets and the concept of *maslahah of ummah* (public benefits). As compared to the Western democracy, it only deals with the choice of majority. On the contrary, *shura*, despite being a majority consensus, it stills consider the views of minority. Furthermore, unlike democracy according to the Western's understanding is a system of governance, *shura* from an Islamic standpoint is a principle of governance.

The institution of *shura* can act as a measure to supervise directors and executives (Rahim, 1998). This requires the directors to listen to other people such as the executives before making any decision. Since the decisions made by the company not only affecting the company but also its internal and external constituencies, it is suggested that other stakeholders involving the employees, the customers, the community, the religious authorities etc. In the case of Islamic banking for example, even though the depositors are actually the one which contributes a substantial amount of capital to the bank, they have no say and no voting rights in the bank.

Therefore, it is more ethical to consider their viewpoints before the directors can make any decision.

#### 4.2.3 Shari'ah-Infused Value Individuals

Another internal force that could help in establishing and maintaining the effective corporate governance is individuals who *shari'ah* values have become part and parcel of themselves. This is what we call *shari'ah*-infused value individuals. As have been previously described, if an organization consists of a group of *insan muttaqun* (pious individuals), this will ensure an effective corporate management and governance.

Nowadays, we can read from the newspapers, watch in the televisions and listen from the radio, various social illnesses committed by the individual who is Muslim. Bribery, theft, incest, abortion and prostitution are some of the ethical problems that happen even in the Muslim community. In addition, what makes us wonder is that such uncivilized actions are also done by those who we believe understand the religious teachings, at least by looking at their physical appearance. They read the *Qur'an*, they pray five times a day, they fast during *ramadhan* and they claim that they are Muslim, but at the same time, such religious activities cannot hinder them from wrongdoings. If we refer to the *Qur'an*, it has clearly stated that;

***“Recite what is sent of the Book by inspiration to thee, and establish regular prayer: for prayer restrains from shameful and unjust deeds...”***  
***(29:45)***

Hence, we can conclude that even though they know Islamic values but they cannot internalize those values in themselves. Therefore, here is some guidance in internalizing Islamic values in oneself.

##### a. Education

Education is an important aspect in building up a good human being. It is this educational process that determine whether one person can behave like an 'abd or like an evil. In order to generate an ethical Muslim, we need to have a holistic educational system. This system should aim at producing a spiritually-enhanced and technically-competent human being.

According to Al-Ghazzali, the education of the children is an important duty (Umaruddin, 2003). This is in line with the Prophet's saying regarding the responsibility of parents in educating their children;

*“Narrated Abu Huraira:*

*The Prophet said, "Every child is born with a true faith of Islam (i.e. to worship none but Allah Alone) and his parents convert him to Judaism or Christianity or Magianism, as an animal delivers a perfect baby animal. Do you find it mutilated?"*<sup>4</sup>

If he is educated in the traditions and goodness, he will surely follow the truth when grown up, and will attain happiness in both the worlds. However, lack of proper education ruins the child. Therefore, parents should train their children in good conduct, and keep them away from bad company.

While this should be our aim, we therefore need to look at the current educational system especially what so far has been practiced in Malaysia. In Malaysia, it is very sad to accept the fact that we actually implement

secular-based educational system. Besides successful in producing citizens who can pass all sorts of examinations, there is not much that can be proud of. There is lack of emphasis in imparting moral and ethical values in each and every subjects taught to the students. In fact, Islam and moral becomes a subject on its own and they called them as Islamic and moral educations.

Hasan (1999) claimed that this type of educational system;

*“...is geared toward attaining prosperity and a comfortable life, handling down progress and culture from one generation to the next, in continual search of more luxuries and enjoyment of this life, and attachment to its pleasures. It is aimed at satisfying the base instincts of the people with no direction toward noble goals”.*

As a consequence, in order to produce an ethical engineer, a moral accountant and a pious doctor, our educational system needs a total reformation. However, such reformation should not be done over night. It should be implemented bit by bit so that its affects is long-lasting. This is in line with Islam, whereby it advocates evolutionary change as opposed to revolution (Naqvi, 1994 as quoted in Sulaiman and Willet, 2001);

*“In the case of abolition of slavery, the Prophet did not abolish slavery outright, but instead, abolished slavery in stages. He taught the followers that freeing a slave is a form of piety. The Prophet himself set the example. While providing a slave for his daughter Fatima, the Prophet persuaded her that the housework should be done on alternate days by Fatima herself”* (p. 93)

At the same time, a step-by-step process has also been implemented in the case of prohibition of alcohol (liquor). According to Nasim (1999), there are four stages of prohibition of alcoholic drinks as stated in the *Qur'an*;

***“And from the fruit of the date palm and the vine, ye get out wholesome drink and food: behold, in this also a Sign for those who are wise” (16:67)***

***“They ask thee concerning wine and gambling. Say: “In them is great sin, and some profit, for men; but the sin is greater than the profit”...” (2:219)***

***“O ye who believe! Approach not prayers with a mind befogged, until ye can understand all that ye say...” (4:43)***

*“O ye who believe! Intoxicants and gambling, (dedication of) stones, and (divination by) arrows, are an abomination, - of Satan’s handwork: eschew such (abomination), that ye may prosper. Satan’s plan is (but) to excite enmity and hatred between you, with intoxicants and gambling, and hinder you from the remembrance of God, and from prayer: will ye not then abstain?” (5:90-91)*

In these verses, it is clear that to change something, especially the ones that have been in place for quite some times, it should be done on stage by stage. The first verse was revealed during the time where almost Muslims including the Prophet’s companion consumed alcohol. Therefore, it should be aim at giving explain that will cause them to think. The total prohibition nevertheless was only done after the fourth verse has been revealed, after they have understood the damages which alcohol brings about.



Such beautiful verses should make us think rationally that in order to change the current educational system, it should begin with a series of explanation and trials and errors. What is more important is planning and target so that the implementation will be on certain schedule and if any problem persists, it can be easily rectified.

Therefore, the Ministry of Education should conduct a careful research and come out with an educational system that put a balance emphasis on both ethico-religious and technical aspects. Such educational system should;

*“...be based on purification of the human personality, by way of directing the intellect and its associated functions to reflect on this universe, and reflect within oneself - to arrive at the conclusion of the existence of the Creator, of His Uniqueness, greatness, power, and care and mercy to the human”* (Hasan, 1999)

At the same time, any initiatives done by others in order to introduce such educational system should not be slashed down.

### **b. Love for knowledge**

Man has been endowed with ‘*aql* (intellectual) which makes him the perfect creature. He needs to us the ‘*aql*, to search for knowledge of all kinds. According to Raba (2001), knowledge is one of man’s basic nature and basic purpose at the same time. By knowledge and through knowledge man can know his God. And by knowing his God, he can be a good servant, a good believer and a good Muslim.

The importance of acquiring knowledge has been stated in the Qur’an as the first word revealed to the Prophet Muhammad (pbuh) was,

*“Proclaim! (or Read!) in the name of thy Lord and Cherisher, Who created- Created man, out of a (mere) clot of congealed blood: Proclaim! And thy Lord is Most Bountiful, - He Who taught (the use of) the Pen, - Taught man that which he knew not.”* (96:1-5)

Knowledge is an essential element in making people different in this life and in the life to come. It is actually a key to success. The reason behind the success of most non-Muslims nowadays is because they continue to acquire knowledge. Such situation enables them to control the mind of Muslims. Nevertheless, knowledge should guide man to be a better ‘*abd* and not to go against the teachings of Islam.

Knowledge is the way to achieve faith and happiness. Knowledge is the light that can guide man to know himself and his role in this life as well as how to keep a good balance between all his dimensions.

### **c. Tazkirah (Reminder)**

One of man’s basic characteristics derived from his nature is forgetfulness. According to Al-Attas (1990) as quoted in Raba (2001);

*“...man is also composed of forgetfulness (nisyan)...and he is called (insan) basically precisely because, having testified to himself the truth of the covenant he sealed with God, which entails obedience of His commands and prohibitions, he forgot (nasia) to fulfill his duty and his purpose.”* (p. 44)

Therefore, *tazkirah* plays an important role in reminding Muslims to help them realize their functions in this world, which is to obey the God. In fact, it has become our responsibility;

*“Allah’s Messenger (pbuh) said: “Whoever among you sees an act of wrong should change it with his hands. If he is not able to do so, then he should change it with his tongue. If he is not able to do so, then with his heart, and this is the weakest of faith”<sup>5</sup>*

Apart from that, Allah S.W.T has clearly stated in the Qur’an;

***“But teach (thy Message): for teaching benefits the Believers”. (51:55)***

Nevertheless, we have the tendency to expect the community to do something for solving our problems (Shafaat, 2001). In this case, we expect persons other than us to perform the *tazkirah*. But how do things start in the community? From some individuals! At the same time, we should also understand that the individual is held responsible not only for his own action, but also for errors of fellow beings in his vicinity (Bashir, 1998).

The internalization of values is really a difficult but possible task. In order for values to be internalized in oneself, there need both internal and external forces. The suggestion we made just now i.e. education, love for knowledge and *tazkirah* are among the external forces. Nevertheless, such external forces are meaningless without the power of internal forces. This is what we called *iman* (faith). Without a strong faith, the process of internalization of values becomes more difficult. Allah has stated in the *Qur’an*;

***“It is true thou wilt not be able to guide every one, whom thou lovest; but God guides those whom He will and He knows best those who receive guidance” (28:56).***

A very classical example on the verse above is the Prophet’s uncle, ‘Abdullah who died in *kufr*. Even though he always accompanied and defended the Prophet during his life, he died without submission to Allah. Therefore, we should not feel helpless in our efforts to inculcate the Islamic values in other people and also ourselves. Whether the efforts are fruitful, it is at the Will of Allah.

#### **4.2.4 Human Resource Development**

In any organization, human resource department plays an important role. It is responsible in hiring people, developing their career, determining their salaries, etc. Apart from that, its ‘ideal’ function includes building an employee to become a better person, technically and spiritually. Spiritually-enhanced employee is achieved by implementing the moral codes and behaviors.

Rahman (1996) in Pomeranz (n.d.) had focused on how to internalize ethics in the work place. One aspect is to recruit those who are most likely to have values and virtues. This dimension requires a stringent screening mechanism. Thus, when selecting a candidate, it must be a balanced between job experience, educational achievement and ethical/moral background. However, this is still insufficient since those workers should be employed on a probationary basis until it is evidenced that they are ethical personnel. Therefore, such a strict recruitment process together with the probationary period will at least can reduce the probability of ethical

problems in the work place. The incident of a 10-year old schoolgirl in Johore who has been raped, sodomized and strangled by a security guard and his friends to her death, among other reason is because a very negligent approach in employee recruitment.

Another aspect under the human resource development which is important is training. Training emphasis should not only be placed on the work-related, but also the values and principles. According to Pomeranz (n.d.), refocusing on values promotes security and confidence and strengthens resistance to temptation. Religious/moral speeches, *usrah*, retreats etc should be conducted regularly to create a corporate culture with strong moral and ethical foundation.

Since not all employees are well-versed in the Islamic spheres, they should be exposed to this. For instance, in the case of Islamic banking, the staff needs to be trained in terms of Islamic products and Islamic code of ethics (Chapra and Ahmed, 2002). This is to ensure that they are well-developed technically and spiritually.

### **4.3 External Forces**

#### **4.3.1 Stakeholders**

Stakeholders in a company are someone who has an interest or ‘stake’ on it and are affected by what the company does. Each stakeholder expects the company to behave or react on behalf of their interest. Some of the stakeholder groups have some power to influence the company decision making and company actions. A large company normally has a large number of stakeholders. Although some of the stakeholders can influence the company decision, others just rely on the company management to take decision that is in their interest. Therefore, company has to balance the demands and needs of various group of stakeholders. One of the key issues in corporate governance is to balance the power between different stakeholders and how it is exercised.

The good corporate governance is where stakeholder is become “check and balance” system among them and according to Yaacob (2002, p. 55);

*“The good corporate governance is the responsibility of not just the directors and management of a corporation but also that of all players in the system”.*

Stakeholders who are not involved directly in company management such as employees and shareholders can be a “monitoring eye” to the company management and will ensure the company action will not give detrimental effect to them. In this paper, stakeholders group are divided into four groups which are believed to have different enforcement power. The groups are shareholders, employees, general public and lenders or creditors.

##### **Shareholders**

Board of director has the responsibility for giving direction to the company. They are holding the highest executives powers in bringing the company to achieve its objective. Lack of monitoring to the board of directors will lead to the fraudulent conduct in power. Board of directors will make a decision on their own interest disregard to other stakeholders. Therefore, shareholders should play a major role to ensure their interest and

other stakeholders' interests are given priority by the board of directors when they make any decision. This can be done by closely monitoring the company's activities and shareholders with their controlling interest are able to influence decision of the company through their ability in controlling the composition of the board of directors. However, nowadays, there is a conflict where major shareholders tend to appoint someone that has close relationship with them to be directors of the company to fulfill their own benefits regardless the minority interest. Minority shareholders with less decision will be deprived their right to involve in company decision.

#### **a. Employees**

Another conflict that normally arises is between employees and shareholders. Normally employees request increment in their salary, and this can be exercised at the expense of shareholders by cutting their dividend and in normal circumstances, shareholders will reject the employees' requests. On the other hand, boards of directors that represent the major shareholders tend to increase their salaries or remuneration although the company's financial position is in bad condition. All this thing can be done as they control the information and able to manipulate it by not releasing the negative information to the employees. However, in most of the countries employee's right is protected by the employees act. Nevertheless, the scope and implementation of this act is very limited.

Employees as an internal party and involve directly in the operation can use their "inherent power" to enforce the management if they know their company involves in non-*halal* products or activities. One of the most powerful action can be taken by the employees is to boycott the operation. This will lead the management more aware on the production.

#### **b. General public**

The environmental issue has been growing in the minds of most community (Medley, 1997). Nowadays, general public especially a community and consumers are more concerned about the pollution created by the company. They take a proactive action such as boycott the company that causes pollution. Social responsibility is one of the company responsibility to the public, however, most of them only concern about the profit and release the pollution burden to the public's shoulder. The argument for ignoring this responsibility among other things is very costly for the company to reduce or to operate in clean environment as they need to invest in high technology to prevent the pollution. Therefore, as a consequence, company just ignores their responsibility to the public. If there is a company that shows their concern towards the environmental problem, it is just to portray the company's good image. However, community are expecting the company to carry out their activity within the boundary of what is deemed accepted by them (Wilmshurst and Frost, 2000 and Said, 2001). In Islamic community, they expect the company to produce *halal* products in lawful manners. Therefore, it is unethical for the company to produce non-*halal* products and sell it to the Islamic community. Indeed, company should disclose all the necessary information regarding the product to reduce the community curiosity. Hence, when the company is

successful meeting this “contract”, this leads to the congruence between the public and the company and company will be more acceptable as part of the society.

Community can be a significant force to the company as they are also the consumer of the company’s products. Therefore, company is ultimately depending on their purchasing behavior. Community can boycott products of a company which causes pollution or has been unethical in performing their operations. They can force the company to be more ethical and concern about the environment. Company should produce a product that benefited the community without causing any damage to the environment.

### **c. Lenders/Creditors**

Most of the large company is depending on the financial lenders to run their operation. According to Basel Committee (1999), the primary agents for good corporate governance are board of directors and senior bank management. In modern economic system, lenders especially bankers or credit company play a major role to ensure that the company operation is running smoothly. Most of the time, before bankers or creditors extending financial facilities to the company, they will thoroughly examine the company’s financial reports. Therefore, this implicitly will be a monitoring process to the company and although after releasing the facilities to the company, some banks still request the company’s financial report. Hence, the board of directors will be more careful in managing the company. Banks will ensure any action taken by the company will not give any detrimental effect to them to the extent that they are not able to pay back the loans. As a consequence, board of directors’ action will be based on the interest of all parties and not just on their own interest. Corporate governance can be improved by addressing a number of legal issues, enforceability of contracts, clarifying governance role, ensuring company is free from corruption and bribery, law and regulations aligning the interest of managers, employees and shareholders (Basel Committee, 1999).

All in all, it seems that the stakeholders group can be an enforcer to the company’s management. However, it is quite difficult to balance all the needs of the stakeholders as each group has different interests. Good corporate governance also cannot ensure all the interests will be met by the company. Therefore, it always happens when the dominant groups satisfy their interest regardless of other groups. Currently, there is a lot of code of ethics are being developed. Indeed, it is useless if the codes of ethics are surrounded by unethical people. This people are very creative and will try to find any room to do unethical action to meet their own interest. Nevertheless, these problems can be solved if everybody in the groups internalized Islamic values. Any action is deemed as worship to Allah. Therefore, any action will be in lawful or ethical manner to get the blessing of Allah and to achieve *falah* as ultimate objective.

### **4.3.2 Legal Requirement**

The second external force is the legal requirement. Legal requirement is something needs to be followed by the company. This is the responsibility of the national regulatory agencies to ensure robust and effective monitoring

and surveillance of company. Company as a legal personality is subject to law and rules which govern its existence and conduct (Koh, 2001). We have grouped legal requirement into three group consists of external control, accounting standard and acts. This requirement is important to ensure the company is properly managed and to protect the interest of stakeholders. Although it cannot ensure 100% free from malfeasance, at least to a certain extent, it can reduce the risk of wrongdoing.

#### **a. External Control**

Currently there are two boards as the main company's external control which is external auditor and security commission (SC) for the listed company. The main objective of external auditor is to give a true and fair view of company financial reports. External auditor also will ensure there is no dubious accounting practice used by the company. External auditor can be assumed as a "Business Police" in monitoring the company activities especially from the financial view. However, the external auditors should adopt a stakeholder orientation in addition to current shareholder (Vinten, 2003) to meet the need of wider interested groups. Nevertheless, external auditor functions have been questioned and in hotly debated due to the collapses of few gigantic corporations such as Parmalat, Enron and WorldCom as a result of the failure in accounting practices. External auditor has loose their integrity and credibility as a body that should govern the company and not to help the company manipulate accounting practice. Most of the external auditor now has been a "business partner" rather than "business police". They involve in auditing and consulting for the same company.

The new external control to monitor Islamic corporation is National *Shari'ah* Advisory Council (NSAC). NSAC is established to guide the Islamic company not to violate the *Shari'ah* law. NSAC will come out the guideline that needs to be followed by the Islamic companies. However, currently NSAC is not actively involved in company's operation. They only focus in the policy development rather than closely monitoring the company's operation. Therefore, we believe NSAC need to do random checking on the company that claim they have met the Islamic requirement to ensure there is no malpractice. In other words, the NSAC should act as the centralized SSB.

#### **b. Accounting standard**

Accounting standard is the important tool to regulate business activities. In fact, accounting standard is not just a regulation but pulse of the company. Without good accounting practice, company is unable to know their profit, to choose pricing strategy, to do strategic planning and other decision. Currently, most of the company is regulated by International Accounting Standard (IAS) and the standards at the operation country such as Malaysia Accounting Standard (Malaysia) and Financial Accounting Standard Board (US).

However, some of accounting standards have loopholes that give room for manipulation it. This has been proved by the Enron case. The sanctioning of off-balance sheet financing vehicles and Special purpose

entity by the FASB and SEC provide an opportunity for Enron to hide most of its debt and mislead creditors and investors (Baker, 2002). Enron case showed to us what will happen to the weakness accounting standards. If the accounting standard is more tighten and concern about the stakeholder interest, Enron and other cases may not happen.

For Muslim corporation, the additional standards have been established to cater the unique feature of its operation and the standards are Accounting, Auditing and Governance Standards for Islamic Financial Institution (AAOIFI) and MASBi-1 for Malaysia. The objective of AAOIFI are to develop accounting and auditing that relevant to Islamic financial institution, to disseminate accounting and auditing thoughts relevant to Islamic financial institution and its applications, to prepare, promulgate and interpret accounting and auditing standards for Islamic financial institution and to review and amend accounting and auditing standards for Islamic Financial Institution (AAOIFI, 2002). On the other hand, MASBi-1 objectives are to provide a basis for the presentation, disclosure and guidelines of financial statements of Islamic financial institution. AAOIFI and MASBi-1 are created based on *Shari'ah* guidelines. These additional standards are to promote the Islamic company operate in healthy business environment. At least it can reduce malfeasance of the company and enhance the quality of financial report.

#### **c. Acts**

The acts in Malaysia that directly relate to the company are Companies Act 1965, KLSE listing requirement, Financial Reporting Act 1997, Securities Industry Regulation 1999 and Income Tax Act 1967. All these acts are created to regulate the company in their financial reporting. Company is enforced to follow all the acts that applicable to them. By having these types of acts can help the government to promote the best practice of corporate governance. Therefore, its will reduce the case of corruption and accounting fraud.

In addition to the above acts, we suggest the government should impose *zakah* act to the Islamic organization. *Zakah* as one of the Islamic pillar is paid for the benefit of the needed and poor people. The principle underlying on this principle is to purify the company wealth. Although it sounds odd to make it legal regulation, at least it can nurture Islamic companies to be more responsible to the society.

All in all, legal requirement is very important to enforce the company as *Qur'an* never reveals everything. *Qur'an* just give an abstract overview on what should be done, therefore, we need a clear standard to regulate a company. Nevertheless, the standard should not contradict with what has been revealed by *Qur'an*.

#### **4.3.3 The Institution of Hisba**

*Hisba* is an important socially religious institution under the authority of the state that has been practiced by the Muslim society since the early period of Islam (Rahim, 1998) which Prophet Muhammad (pbuh) was the first *muhtasib* (active participle of *hisba*). The establishment of this institution is to “safeguard society from deviance, protect the faith, and ensure the

welfare of the people in both religious and worldly manners according to the Law of Allah<sup>67</sup>. Apart from safeguarding the limits of Allah from being violated, protecting the honor of the people and ensuring public safety, hisbah is also responsible in monitoring the marketplace, craftsmanship and manufacturing concerns to make sure that the laws of Islam are upheld by these entities.

Based on the Divine code of approved social behavior, the *muhtasib* will enforce this code to enjoin what is right and forbid what is wrong. The responsibility borne by the *muhtasib* requires him to be a Muslim with a high degree of integrity, insight, reverence, and social status. He must be knowledgeable in Islamic jurisprudence, with a high degree of in-depth knowledge of the local customs and mores.

Hayashi as quoted in Rahim (1998) has listed out the duties of this *hisba* which is relating to the corporate and business affairs:

- a) to ensure a fair trading transaction in the market,
- b) to check business frauds,
- c) to audit illegal contracts,
- d) to keep the market free from unhealthy competition
- e) to prevent necessities from being hoarded” (p. 64).

In addition to that, the duties of the *muhtasib* permeate throughout every aspect of human, animal and environmental life. Therefore, the rights of each one of these categories should be protected according to *Shari’ah* law, order, norms and socially accepted practices. If this is the case, it can reduce the level of environmental degradation as well as animal exploitation initiated by the greedy and individualistic business entities.

As time passes by, this institution of *hisba* has been abandoned in our Muslim society. That is perhaps the reason why the level of business and ethical corruption keep mushrooming nowadays. Thus, if only this institution can be re-established, we believe that at least it can become an external force to ensure the right conduct and forbid unethical behavior in the wider social concern (Rahim, 1998).

The establishment in current times might be different from the Prophet’s time. As compared to the one single institution of *hisba* during the Prophet’s time, in current situation, it can be more than one institution. All institutions that act as a public watchdog can be regarded as the institution of *hisba*.

#### 4.4 Shari’ah Law

Among all of the acts, laws and standards, *Shari’ah* law is the ultimate law that govern everything, not just the company but also included the legal authority that prepare accounting standards and acts and also to the stakeholders. According to Karim (1995), *Shari’ah* doctrine acts as the basic value and fundamental principles to guide the Muslim in all aspect of their life at all times. *Shari’ah* is a Divine law and should be the major reference for the company. Good governance practice can be achieved by adopting *Shari’ah* law because it is not just focusing to the worldly issues but goes beyond to the hereafter. However, according to Karim (1995), *Shari’ah* does not cover all the issues and detail for which an accounting policy would be required, therefore, the other accounting standards can be used provided they do not violate the *Shari’ah* injunction.



#### **4.5 Worldview - The Most Outer Layer**

Islamic worldview represents a dual worldview; a belief in the world and the hereafter. Islamic encompasses all aspects of man's existence. Therefore, according to Hassan (1998), all virtues performed by individual or group are consider religious. If individual considers their action as worship to Allah; corruption, accounting fraud and other problems will not happen. Individual will try to seek Allah pleasures. Hence, Islamic worldview can be considered as governance that imposes in human action.

## 5.0 CONCLUSION

Corporate governance will become more important in the future. As more people become increasingly aware of the responsibilities of a corporation towards the development of the society, they will continuously monitor the activities of the corporation. Western-based corporate governance has so far failed to meet the expectations of the various parties. The collapses of Enron, Parmalat, WorldCom and even the MAS have proved such contention.

In our arguments, we have agreed that Islamic worldview, which is based on the belief in this life and the hereafter can contribute to the effective corporate governance. We suggest that human being (or man) becomes the main player in the attainment of corporate governance. If man can have Islamic worldview in himself, he will definitely act religiously and ethically. The principle of *tawheed* has led Muslims to look into the concept of man, universe and religion differently from the Westerners. This in turn, will lead to various sub-concepts which include *amanah* (trust), *khalifah* (vicegerent), *ikhtisab* (accountability) and *'ibadah* (worship). If man can uphold these concepts in himself, values such as *siddiq* (truthfulness), *ikhlas* (sincerity), *'adalah* (justice), *ukhuwwah* (brotherhood) and *mujahadah* (determination) will become part and parcel of his life. Man with such values will ensure the achievement of highest level of men which is *insan muttaqun* (pious individual). Pious individuals are the one who will act in a God-fearing manner and this will hinder them from doing something which is not in line with ethical and religious conducts. Since man is the main element in the system, if each and every man can ingrain the *tawheedic* worldview, with Allah's permission, corporate governance can function effectively.

We also have come out with a model on how to develop an effective corporate governance system. The major components of the system are Board of Directors (BOD), *Shar'iah* Supervisory Board (SSB), management, internal audit (IA) and internal *shari'ah* audit (ISA). To function effectively, several internal forces need to be in place. Those are: internal control and procedures, *shuratic* decision making, *shari'ah* infused values individuals and human resource development. This will be further enforced by the external forces, namely stakeholders, legal requirements and institution of *hisba*.

Without denying the importance of various codes on corporate governance, the effectiveness of corporate governance lies under the shoulder of men. If and only if the Islamic values can be internalized into the Muslims, corporate governance will run properly. Since the internalization of such values is very much influenced by the educational system, therefore we suggest that we need to look at the current educational system and identify all the deficiencies therein. However, since this paper is to just give an overview how *tawheedic* man can contribute to the corporate governance, the issues on education is not discussed here.

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## Notes

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