

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

AZ - Zalzalah 1-8

Corporate Governance in Islamic Institutions

ECIE603002
Islamic Business

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DEFINITION OF CG

1

Cadbury Committee (1992)

The system by which companies are directed and controlled to achieve balance between power and authority in fulfilling responsibilities for shareholders and stakeholders.

2

Organization for Economic Co- operation and Development (OECD)

Corporate governance involves a set of relationships between a company's management, its board, shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined





DEFINITION OF CG

3

Center for European Policy Studies (CEPS)

The system which is created from rights, process, and control, on both outside and inside of companies management. Right is any kind of power which is owned by the stakeholders individually to influence the management process. Process is the mechanism of those rights. Control is the mechanism which enable stakeholders acquire any information about any activities occurred in company.

4

Asia Development Bank (ADB)

GCG contain 4 main values, they are: accountability, transparency, predictability, and participation.





DEFINITION OF CG

5

**Finance
Committee-CG
Malaysia**

The process and structure that are used to direct and manage businesses and companies toward the development of businesses and accountability of companies. The final purpose is to raise the value of shares in a long term, but still paying attention on various interest of stakeholders.

6

**National Committee
of Governance Policy
(KNKG) – Indonesia**

A pattern of connection, system, and process used for the organ of companies (Director, Board of Commissioners, General Meeting of Shareholders) to give value-added to shareholders in a long term, but still paying attention on various interest of stakeholders, based on the law and norms applied.

7

Ministry of BUMN

Everything related to effective decision-making which comes from companies culture, ethics, values, system, business process, policy, companies organizational structure, aimed for supporting the development of companies, creating effective and efficient resources and risk management, and being responsible to the shareholders and other stakeholders.



CG - IFSB

“in the context of IIFS, good corporate governance should encompass

- (i) a set of organizational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholder,
- (ii) provision of proper incentives for the organs of governance such as the BOD, SSB and the management to pursue objectives that are in the interest of the stakeholders and facilitate effective monitoring, thereby encouraging IIFS to use resource more efficiently, and
- (iii) compliance with Islamic Shari’ah rules and principles” (IFSB, 2006a).





Important Aspects from The Definition of CG

1

- Structure and relationship between company's organ (Director, Board of Commissioners, General Meeting of Shareholders) and stakeholders.

2

- Check and Balance System => balance authority=> Controlling
- Balance relationship among company's organ

3

- Shareholders rights in acquiring information and making decision.
- Transparency process => goal, achievement, performance measurement

4

- Equal treatment for all shareholders.
- Fulfillment of company's responsibilities to all stakeholders.





Philosophical Background of CG

Agency Theory

Principle

VS

Agent

Conflict of interest

Different
interest

Self-interest
(rational person)

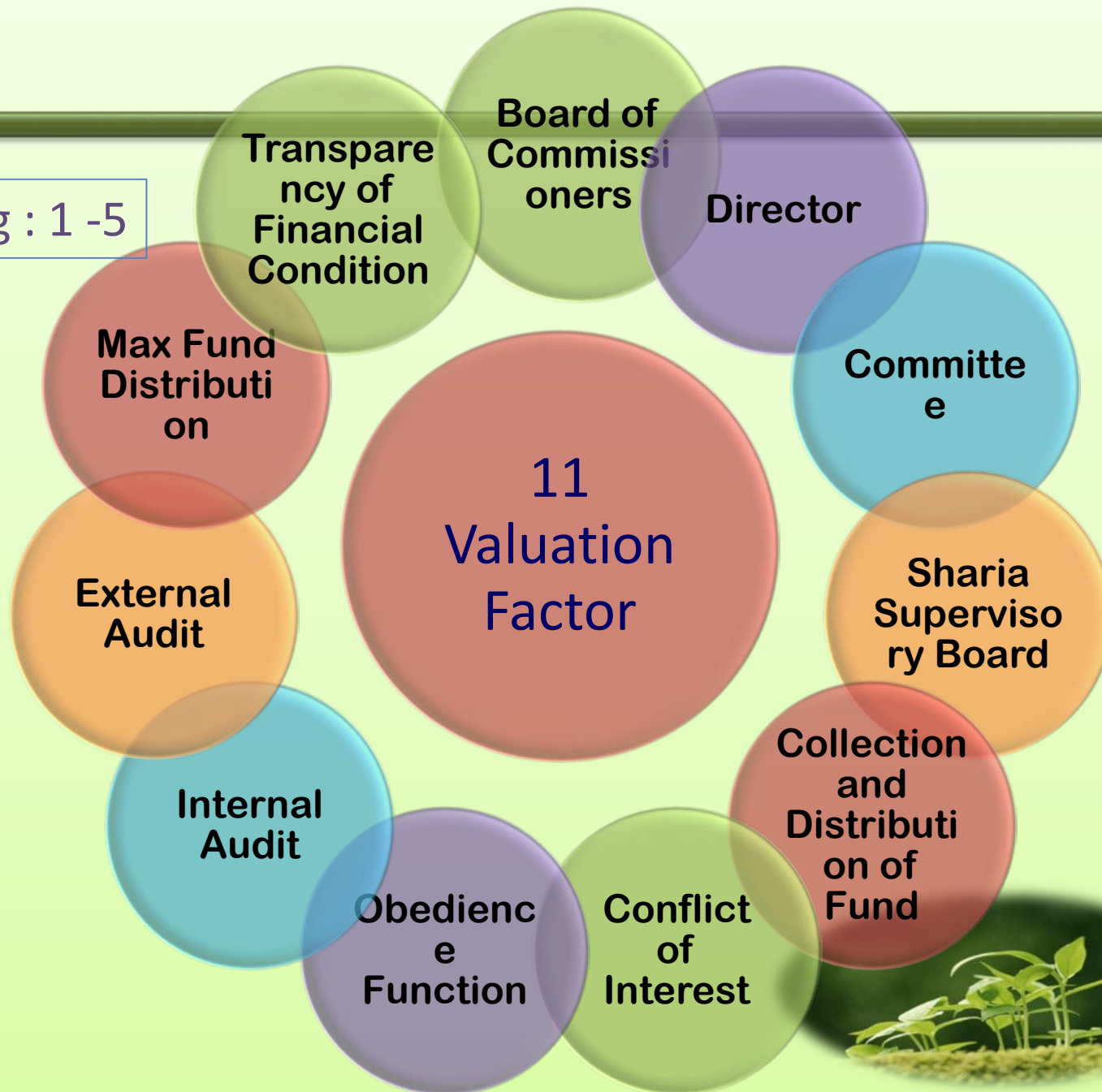
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Assymmetric
information

Agency problem



Rating : 1 -5





Cases related to CG

•Enron and Arthur Enderson LLP Cases:

- Formed in 1995 from a merger of Houston Natural Gas and Internorth, Enron Corp. was the first nationwide natural gas pipeline network.
- Enron made a diversification (As a result of oil and gas booming) such as, future transaction, trading commodity non energy, and financial business.
- In 2001 and 2002, it was revealed that there was financial report manipulation scandal.
- Enron recorded revenue of 600 million US Dollar, while in fact was having a loss.
- Profit manipulation is caused by the desire of company to keep investors interested in its stocks → What is the connection between company's profit and stock price?
- It was found that there was an auditing process fraud done by Arthur Enderson.
- 2nd December 2001, Enron declared bankrupt and fired 5000 employees
- Pension fund has a big portfolio on Enron stocks price of which became so low because of the plummeted Enron stock in Stock Exchange.





Cases related to CG

•Wordcom and Arthur Andersen LLP Cases:

- Worldcom was a long-distance phone company, formed in 1983.
- There was something odd in USD 3.8 billion network expense classified by Worldcom as a capital expenditure.
- That expense classification made the Worldcom's profit increased drastically.
- An investigation revealed that there was a mistake in the report made by Worldcom. It took 1 year to reveal that mistake.
- Arthur Andersen LLP as the external auditor of Worldcom was also considered guilty because it neglected the false financial statement made by Worldcom.
- In June 2002, Worldcom stocks price fell from USD 64,5 to less than USD 1. Employees pension fund which is in form of stocks also took a great loss.
- 17.000 employees was fired





CG in Islamic Perspective

Corporate governance in Islamic perspective has differences in 5 aspects compared to the existing CG:

- Philosophical purpose
- Types of Contract
- Key player and the connection between them
- CG Mechanism
- Tools used to implement CG

Business goals from every business organization in secular perspective:

- Maximize profit
- Maximize shareholder wealth

Business goals in Islamic perspective:

- Material and non-material (godsend) profit
- Influences the corporation behavior → cooperate not compete, or competing with a right conduct



CG in Islamic Perspective

• In terms of contract, secular CG only sees the principal agent relationship between the owner and managers.

Islam has a different viewpoint, every muslim has a bond with Allah as the Creator (principal); therefore, every business activities should be done in order to carry out and fulfill Allah's commands in earth.

In terms of formal contract, secular CG system may change as the era also changes:

- The Sarbanes-Oxley Act 2002 was arranged after the Enron scandal had occurred.
- The CG system in Islam is generated from Quran and Sunnah which are fixed.

In terms of key player, secular CG sees shareholder as the only key player. While the other view states the opposite, Stakeholder is the key player.

- Iqbal and Molyneux (2005) stated that stakeholder is defined as the one whose property right are at stake or at risk due to voluntary or involuntary actions of the firm.
- Shareholder definition in Islamic perspective is more than just about stock holder in a. Shahibul maal in mudharabah contract is also considered as shareholder.



CG in Islamic Perspective

- Organizational structure in Secular CG only guarantee the good corporate governance process.

CG in Islamic perspective, not only need to guarantee the GCG process, but also have to ensure that the sharia principles are well-implemented by the company:

- Auditing should be done to ensure the implementation sharia principle in companies.
- Usually conducted by Sharia Supervisory Board.



CG in Islamic Perspective

- philosophical aspects, including objectives of the company, types of contract involved, key players in the corporate governance practice as well as the relationships between the players.
- Islamic perspective sees the corporate governance practice as Muslim's obligation to God, thus leads to the existence and obedient of the 'implicit' contract with God and explicit contract with humans. In the end, these placed God and Islam itself as key players in the corporate governance practice.



CG in Islamic Perspective

- Islamic financial institutions deal with more complicated financial transactions and must comply with Shari'a rules, it requires relatively stronger internal control.
- Unfortunately, most of the tools are not being practiced yet by IFIs either because less supporting infrastructure or insufficient human resources are available



CG in Islamic Perspective

- Islamic financial institutions (IFIs) do not immune from such mishap. The collapse of Ihlas Finance House (IFH) of Turkey in 2001.
- The current corporate governance practices of IFIs still rely on the conventional corporate governance standard, such as the OECD and the BCBS standard, with adjustment to the shari'ah.



Shari'a Supervisory Board (SSB)

- Definition: An independent body of specialized jurists in fiqh almu'amalat (Islamic commercial Jurisprudence) that has functions in directing, reviewing, supervising the activities of the Islamic Financial Institution (IFI) in order to ensure that they are in compliance with Islamic Shari'a rules and principles.

It is allowed to include experts without specialization in Fiqh Muamalah, but the experts must specialize in Islamic financial institution with a knowledge of Fiqh Muamalah



Sharia Supervisory Board

Consist of at least 3 people, director and significant shareholder are not allowed to be selected as members.

It is allowed to ask for consulting services which experts in business, economy, law and accounting field.

Dismissal: Board of Commissioners recommendation and approval from General Meeting of Shareholders..



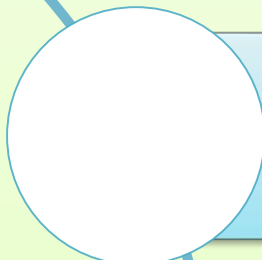

Sharia Compliance Review

- Testing the level of compliance of IFI with sharia rules in every activities.
- The components which is reviewed:
Contract, cooperation, policy, product, transaction, memorandum and article of association, financial report, report (internal audit and central bank inspection), etc.
- Responsibility: Giving opinion on the level of compliance. The responsibility of sharia compliance is still held by IFI management.
- IFI Task: Providing guide, advice, training related to sharia compliance.



Sharia Governance in Selected Countries

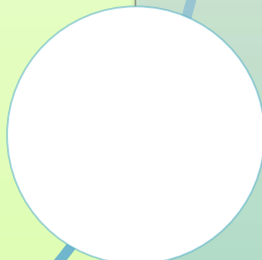
Country	<i>Syariah</i> Authority		Final Authority	Restriction
	Central Bank	Islamic Financial Institution (IFI)		
Malaysia	<i>Syariah</i> Advisory Council	<i>Syariah</i> Committee	<i>Syariah</i> Advisory Council	<ol style="list-style-type: none"> 1. Members of SAC cannot serve IFI 2. One SA can only serve one IFI in same category
Pakistan	<i>Syariah</i> Board	<i>Syariah</i> Advisor	<i>Syariah</i> Board	<ol style="list-style-type: none"> 1. Members of SB can serve IFI 2. One SA can only serve one IFI
Kuwait	N/A	<i>Syariah</i> Supervisory Board	<i>Syariah</i> Supervisory Board	No restriction
Indonesia	N/A	<i>Syariah</i> Supervisory Board	Dewan <i>Syariah</i> Nasional-MUI	No restriction
UAE	Higher <i>Syariah</i> Authority	<i>Syariah</i> Supervision Authority	Higher <i>Syariah</i> Authority	No restriction
Bahrain	National <i>Syariah</i> Board	<i>Syariah</i> Supervisory Committee	National <i>Syariah</i> Board	No restriction
Qatar	N/A	<i>Syariah</i> Board	<i>Syariah</i> Board	No restriction



Governance system in Islam: no-injury and maslahah. An asset exist for the maslahah of everyone and no one may use asset as a tool that would harm others.



Islam teaches human to develop morals and how to use it to accelerate economic coordination.



Islam norms teach policy and business direction. Islam appreciates investors, business initiator and entrepreneur role in decreasing poverty, and giving benefit to communities. Business function is guided by Al Quran and Sunnah. Encourage the social responsibility.



islam teaches entrepreneur about betterment, striving to the self, and a shift from selfishness to *altruism* (generous) in terms of decision-making and setting the price and output.

Islam do not accept selfishness, but Tag el Din (2008) allowed self-interest (not selfishness) using mushaha and mughbana terms (underrating and haggling). Self-interest is considered as motivation and market is considered as exchange center.

Working with cooperation, compassion, justice, charity, solidarity and producing economic efficiency which can be socially accepted.



Islam: An entrepreneur has a right to own properties and economic resources, generate profit, expand jobs, and invest. Ownership: non-absolute. Mankind acts as a trustee, every wealth is given by Allah to individuals and they have to use it based on Al Quran and hadits guidance.

Islam encourages professionalism in entrepreneurship and it is prohibited to violate the professionalism in order to gain profit: Kahf 92, Iqbal, mirachor 2004.

Iqbal-mirakhor 2004. Islam acknowledges provate property, but it should not violate society rights, there is a moral limit (=rice) as a filter to avoid any social and private conflict..



Iqbal-mirakhor 2004: 3 basic conditions to maintain rights of property:

- Property is acquired without violating any rule.
- Ownership does not cause harm to others.
- The acquisition of property should not invalidates valid claim.

Ethics on how to manage property: Quran 4:29, hadits, it is forbidden to waste (mubazir) any resources, properties and wealth.



Azid et al.: Qur'an 5:1

“ye who believe! Fulfil obligations” .

This verse has two dimensions:

1. firstly, there are the divine obligations that arise from spiritual nature of human beings and its relation to Allah (swt);
2. secondly, the human being undertakes mutual obligations in its human and material life, express and implied. So this is the duty of human beings to discharge all their obligations faithfully whatever the nature of the obligation, explicit or implicit. The fulfilment of the obligations is considered as one among the good deeds and, therefore, Allah (swt) loves those who fulfil their obligations. If someone does not fulfil his/her obligations he/she is declared as faithless.



“Basic conditions to maintain lawful acquisition to property are that (1) property should not have been acquired by unlawful means (means repugnant to Shari[ah]), (2) the acquisition and its continuity should not result in any damage or harm to others; and (3) the acquisition of property should not invalidate any valid claim nor should establish a non-valid one”

