

ETHICAL CORPORATE GOVERNANCE BASED ON ISLAMIC PERSPECTIVE: A PROPOSED EQUATION MODEL

Dianidza Arodha

State Institute of Islamic Studies
(IAIN) Jember
arodhamine@gmail.com

Khairunnisa Musari

State Institute of Islamic Studies
(IAIN) Jember
khairunnisamusari@yahoo.com

Abstract

Financial crises in various countries in the last two decades were resulted by poor corporate governance. The failure of some companies and the emergence of financial malpractices that occurred due to crisis are the evidence of the weak practice of good corporate governance. One of the weak practices of good corporate governance is the separation of religious values with economic activity. Good corporate governance actually is not only about how to be excellence or to win the hearts of the shareholders and stakeholders. More than that, good corporate governance can be the engine of economic and social transformation because there is actually a relation of economics to social values. This paper takes a theoretical approach and reviews the existing literature to develop ethical corporate governance based on Islamic perspective. The paper develop the variable of the ethical corporate governance through a proposed mathematical equation model. This paper shows that the features of the ethical corporate governance should be driven also by faith-based rationalism and the ethical-religious values criterion.

Keywords: equation model, mathematical model, corporate governance

1. Introduction

The issue of good corporate governance (GCG) become a public's attention since the financial crises occurred in many countries in 1997-1998.¹ Large corporate failures and financial scandals are considered as the result of the bad practice of corporate governance (CG). Because of that, many people have focused attention on the importance of GCG. Kirkpatrick (2009) mentions the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements. Then, the development and refinement of corporate governance standards has often followed the occurrence of CG failures that have highlighted areas of particular concern.

In Indonesia, Sumarno, Widjaja & Subandriah (2016) also claim one major factor for Indonesian companies vulnerable to the negative impact of financial crisis in 1997 was the weakness of internal mechanisms of corporate governance. Similar to the experience of other corporate entities in the region, the failure of Indonesian companies to implement corporate governance practices carefully in the management of their companies are associated with a number of factors. For better governance in Indonesia, Sato (2003) explains a need for a combination of measures targeting business group themselves, measures targeting creditors, and measures for preventing collusion.

Absolutely, CG is one of the essential elements of corporation as it plays roles to design and promote principles of fairness, accountability and transparency. Study of Giroud and Mueller (2011) find that weak governance firms have lower equity returns, worse operating performance, and lower firm value, but only in noncompetitive industries. When exploring the causes of the inefficiency, the study find that weak governance firms have lower labor productivity and higher input costs, and make more value-destroying acquisitions, but, again, only in noncompetitive industries.

So, referring to Organization Economic Corporation Development (OECD, 2004), CG framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets. Then, the legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable. Ahmed (2014) and Martina (2009) elucidate also that CG is broadly concerned with who has the right to control the allocation of resources in a firm. It is an effort conducted by some interested parties in a company to perform their operation appropriately absed on the right and duty of each side. The application of GCG principles is supported by an appropriate regulation and GCG mechanism.

Further, Hasan (2009, 2008) argue that CG model in Islam has its own unique features and presents distinctive characteristics in comparison with the Western concept. It combines the element of *tawhid*, *shura*, *shari'a* rules and maintains the private goal without ignoring the duty of social welfare. A concept of CG in Islamic perspective does not differ much with the conventional definition as it refers to a system by which companies are directed and controlled with a purpose to meet the corporation's objective by protecting all the stakeholders' interest and right. Islamic CG refers the premise of Islamic socio-scientific epistemology which is premised on the divine oneness of God.

Unfortunately, Hasan (2009) claims the surveys of Siddiqi (1981) and Haneef (1995) on the contemporary literatures on Islamic economic thought prove that there are lack of references and discussion on the topic of corporate governance from Islamic perspective still occurring For this reason, this study would like to take a theoretical approach and reviews the existing literature to develop ethical

¹ Shimomura (Ed.) (2003) affirms that since the beginning of the 1990s, aid donors have increasingly stressed that good governance, together with democracy and protection of basic human rights, is dispensable for sustainable economic development. In 1991, the Development Assistance Committee (DAC) of OECD emphasized that the concep of 'governance' has assumed a more cental focus as an area of key attention by both bilateral and multilateral donors, and participatory development cannot be achieved without the development of good governance, which is composed of competence and honesty, public accountability, broader participation in discussion and decision making on central issues.

corporate governance based on Islamic perspective in order to contribute in developing the knowledge of Islamic economics, particularly in GCG.

2. Corporate Governance in Islamic Perspective and Hypotesis Development

Many definitions and ways for explaining the CG. Choudhury and Alam (2013) note that the theory and practice of CG is concerned with maximization of the common interest of a network of factors that interface with the operation, organization and linkages of the objectives and goals of a corporation. Hasan (2008) claims the Western concept of CG is dominated by two models, the Anglo-Saxon and the European models. The Anglo-Saxon model of CG is considered as the most dominant theory championed by the United States and the United Kingdom. The stakeholders' model of CG is practiced by majority of the European countries.

In Islamic perspective, as the foundation of Islamic faith is *Tawhid*. Hasan (2008, 2009) argues the basis for the CG framework also emanates from this concept. Allah says in QS Ali 'Imraan [3]: 191, "Men who celebrate the praises of Allah standing, sitting, and lying down on their sides, and contemplate the wonders of creation in the heavens and the earth, (with the thought): "Our Lord! Not for naught Hast thou created all this! Glory to Thee! Give us Salvation from the penalty of the Fire". This verse provides fundamental principle of governance where everything created by Allah has a purpose and human being is created to be the world's vicegerent. By putting a trust to mankind as a vicegerent, Allah plays actively roles to monitor and involve in every affairs of human being and He is aware and knowing everything all the times. Allah says in QS. Luqman [31]: 16, "O my son! If it be (anything) equal to the weight of a grain of mustard seed, and though it be in a rock, or in the heavens or on the earth, Allah will bring it forth. Verily, Allah is Subtle, Well-Aware". As Allah knows everything and all mankind is answerable to Him, the principle of *tawhid* shall be the foundation of the CG model in Islam. Hasan (2012) maps the differences between the Western CG and Islamic CG as shown below by Table 1.

Table 1.
The Differences between Western Corporate Governance
and Islamic Corporate Governance

| Aspects | Shareholder | Stakeholder Model | Islamic Model |
|-----------------------------|---|--|---|
| Episteme | Rationalism and Rationality Ethics is social | Rationalism and Rationality Ethics is social construct | Faith-based rationalism: Aqidah, Shari'a and Akhlaq Ethics is holy revelation |
| Rights and Interest | To protect the interest and rights of the shareholders | The right of community in relation of the corporation. | To protect the interest and rights of all stakeholders but subject to the rules of Shari'a and ethics. |
| Corporate goal | Shareholders profit | Stakeholders and Social Welfare | Maqasid Shari'ah (<i>Maqasid Shari'ah</i> means protect of the welfare of the people, which lies in safeguarding their faith, life, intellect, posterity and wealth (Al-Ghazali, 1937): Ethics is part of <i>maqasid shari'a</i> |
| Nature of Management | Management dominated | Controlling shareholder Dominated | Concept of Khalifah (vicegerency), Shura (consultation) and subject to Shari'a and Ethics |
| Management Boards | One-tier board; No specific committee on ethical issues | Two-tier boards; Executive and supervisory Board; No specific committee on ethical | Shari'a board or any institution that responsible on the Shari'ah and ethical issues. |
| Nature of Business | No specific restriction on any kind of business | Less prioritized; No specific restriction on any kind of business | Only Shari'ah and ethical permissible activities are allowed. |

Source: Hasan (2012)

Refers to the table above, it can be known the different between Western and Islamic corporate governance. **The first**, the aspect that different is about episteme, how the CG can be applicated. If the Western concept, it formulation only from rationality, while in Islamic concept, apply CG based on the rational in faith, that is trough *aqiidah*, *shari'a*, and *akhlaaq*. **Second**, right and interest. In relation with the shareholder and stakeholder, the Western concept protect the personal right and interest that have

relations with the institution. Different in Islam, the concept of right and interest only apply based on shari'a principles. **Third**, corporate goal if in Western concept only to get the maximize profit, but in Islam, corporate goal must appropriate of *maqasiid shari'a*. **Fourth**, the nature of management in Western concept present that be dominated by all shareholders and stakeholders. In Islam, nature of management based on the concept of *khalifah* and *shura*(conculatiton). **Fifth**, the board management in Western concept don't have the special commitee to handle the problem about ethics, while in Islamic concept of board management must relied on *shari'a* and have the ethics issues commitee. **Sixth**, the nature of business in Western concept aren't be limitationed, all kind about business. But in Islam, the nature of business only to the appropriate business activity in *shari'a* permitted.

So, there are outlines which become variables of CG in Islam to develop Ethical Corporate Governance (ECG). Its variables are: epistimology, rights and interest, corporate goal, nature of management, management board, and nature of business. From that all can be breakdown into some subvariabel. The variable and sub variables of ECG as shown Table 2.

Table 2.
Variables and Sub Variables of ECG

| Variables | Sub Variables |
|-----------------------------|---|
| Episteme | 1. <i>Aqidaah</i> 2. <i>Shari'a</i> 3. <i>Akhlaaq</i> |
| Rights and Interest | - |
| Corporate Goal | 1. <i>Diin</i> 2. <i>Nafs</i> 3. <i>Maal</i> 4. <i>Nashl</i> 5. <i>'Aql</i> |
| Nature of Management | 1. <i>Khalifah</i> 2. <i>Shura</i> |
| Management Boards | 1. <i>Shari'a</i> Board 2. Another institution be related |
| Nature of Business | - |

Overall, referring to Ahmed (2014) and Iqbal and Mirakhor (2004), Islamic shari'a does not take side in the shareholder versus stakeholder argument. The general egalitarian nature of any religion, Islam in particular, suggests that the stakeholder rather than the shareholder model is more appropriate. The governance model in Islamic economic system is designed to protect rights of all parties (stakeholders) who are exposed to any risk resulting from the activities of the firm. Stakeholder model is more holistic and largely normative but it lacks the simplicity of the utilitarian argument in the shareholder model. Indrawaty and Wardayati (2016) assert also that CG in Islamic perspective always associates the concept of governance with things that are transcendental and faith. This is a consequences of Muslims's faith to Allah SWT. The value of *tawhidi* is the basis for any belief, thought and behavior of a Muslim, including in the understanding of CG. One of the principles of *tawhidi* is the principle of accountability and justice. The value of Islam always encourages it people to be fair in every aspect, both in the matters of faith sharia or morals as the consequences of faith and to achieve the degree of piety as written in QS. Al Maidah [5]: 8 "*O you who have believed, be persistently standing firm for Allah, witnesses in justice, and do not let the hatred of a people prevent you from being just. Be just; that is nearer to righteousness. And fear Allah; indeed, Allah is Acquainted with what you do.*"

3. Research Method

This study is a qualitative research with a theoretical approach and reviews the existing literature to discover and report the relationship among different aspects of the phenomenon for developing ECG Model based-on Islamic perspective. As a qualitative approach, this study can be categorized as applied research. This paper takes The paper develop the variables of ECG Model and then converting to the proposed mathematical equation model based on the generic conceptual framework in Islamic economic. This paper shows that the features of the ECG Model should be driven also by faith-based rationalism and the ethical-religious values criterion. The method of analysis in such unified and causally interrelated, complementary world-systems come about by means of circular causations between the learning domains of $\{\theta, X(\theta)\}^2$.

4. Result

4.1 Proposed Model For Ethical Corporate Governance (ECG)

Previously, it have been studied the number of variables which able to influence the ECG in Islamic perspective. As for its variables are: Epistemology (Y1), Rights and Interest (Y2), Corporate Goal (Y3), Management (Y4), Management Board (Y5), and Nature of Business (Y6). There are some aspects influence in applying of ECG. **First**, epistemology to represent how implementing the ECG with based faith-rationalization, among others there are *aqidaah*, *shari'a*, and *akhlaaq*. **Second**, right and interest to be made account for civil rights. **Third**, corporate goal to represent applying of life target in general according to Al-Ghazali and Ash Shatibi which is often referred by *maqasid shari'a*. *Maqasid shari'a* consist of the target of belief in God (*diin*), intellect (*'aql*), life (*nafs*), propersity (*nashl*), wealth (*maal*). **Fourth**, nature of management where in applying of ECG have to measure up to leadership (*khalifah*) and always do shura to have interaction with others utilize to consult about dealt only with things about EGC. **Fifth**, management board which consist of shari'a board and pertinent other institution and hold responsible according to shari'a. Last variable is nature of business which the executed business have to as according to conception of shari'a. All of these six variables is believed to influence process as perfect as ECG-applied. Figure 1 shows ECG in Islamic perspective with six variables and its sub-variables: Epistemology (Y1), Rights and Interest (Y2), Corporate Goal (Y3), Management (Y4), Management Board (Y5), and Nature of Business (Y6). All of them are the latent variables. They still needs some indicators to measure into the quantitative measuring.

² *Tawhidi* knowledge -induced unified world system (Chodhury, 2005, 2007).

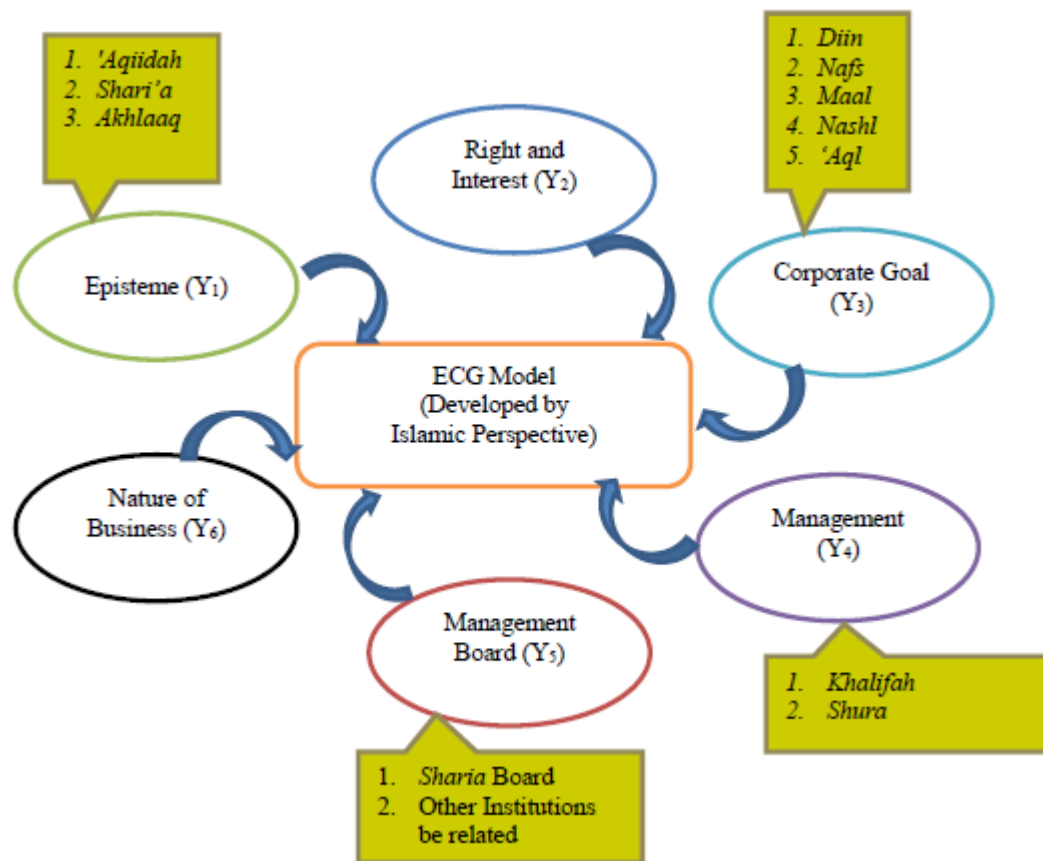


Figure 1.
The Variables of ECG Model

4.2 A Proposed Mathematical Equation Model

This proposed model is according to Musari & Simanjuntak (2015) who developing the existing models of *Tawhidi* String Relationship (TSR)³ and SIZ Model⁴ into the generic conceptual framework in Islamic economic as below,

$$H_0 : W(\theta)_i = 0 \quad \dots\dots\dots (1)$$

$$H_1 : W(\theta)_i \neq 0 \quad \dots\dots\dots (2)$$

³ TSR is a conceptual framework of research methodology. Choudhury (2005, 2007) has introduced TSR as the foundational epistemology for the Islamic economic and finance study. TSR describes all the science in the world (θ) is a fraction of the knowledge of God (Ω). Science of God on earth is scattered among the many human beings, with a mastery of a different type and level ($\theta_1, \theta_2, \theta_3 \dots N$). TSR emphasizes the process of interaction, integration, and evolution of human knowledge. This theory is constructed by placing Allah as a source of knowledge that is absolute and is represented by the Qur'an and Sunnah to be interpreted through the process of evolution of human thought which is then implemented. The implementation process of knowledge which is done by human then must be re-evaluated by reference to the Qur'an and Sunnah.

⁴ SIZ model is developed by Suroso Imam Zadjuli, the founder and also the first Head of the Islamic Economics Doctoral Program, Postgraduate Program, Airlangga University. Musari & Simanjuntak (2015) mention that the model asks an integrative research (mergers) which is a combination of quantitative-qualitative research which aims not only to capture a variety of facts or phenomena through observation in the field, but also to confirm the number of variables and to generalize them on population. Given the research is the Islamic study, the quantitative-qualitative analysis also includes *kashf* analysis. In the study of Islamic economics, the *kashf* analysis is something inherent in any research because it contains *Tawhidi* dimension.

$$[(\Omega, S) \rightarrow \theta] = (\theta \in (\Omega, S)) \dots\dots\dots (3)$$

$$Z(\theta) = (\theta, W, \zeta) \dots\dots\dots (4)$$

$$W(\theta) = (\theta, X_i, Y_i) \dots\dots\dots (5)$$

$$Z(\theta) = W(\theta) + \theta + \zeta \dots\dots\dots (6)$$

$$W(\theta) = X_1Y_1 + X_2Y_2 + X_3Y_3 + X_nY_n + \theta \dots\dots\dots (7)$$

Note:

- Ω : The Qur’anic domain of complete knowledge;
- S : Sunnah as transmission mapping of the *Qur’anic* Law of Unity;
- θ^* : Interpretation by the participatory learned community;
- $[\Omega \rightarrow , \rightarrow \theta^*]$: Fundamental epistemology of *Tawhid*, the monotheistic law;
- θ : Set of knowledge of unity derived from the fundamental epistemology of (Ω, S) ;
- $X(\theta)$: The knowledge-induced socio-scientific variables (This determine the impact of embedded knowledge that gives these variables and entities their material meaning)
- $W(X(\theta))$: Well-being criterion of attained levels of unity of knowledge in the *Tawhidi* unified world-system relating to specific problems and variables;

As the explanation for the above generic conceptual framework, Musari & Simanjuntak (2015) mention that the functional realization of unity of knowledge is premised on both (Ω, S) and encompasses all systems, therefore, (Ω, S) is the unique and universal epistemology of the Islamic universe. So, each of conceptual framework of Islamic economic research should be a process to find the truth with each criterion of truth in finding the right knowledge. True is relative, then the effort of the thought process to produce the correct knowledge is also different. Each way of thinking has what is referred to as criteria, variable (X_i, Y_i) , paradigm, and the source of knowledge. In the Islamic economics, the process of research in the aspect of epistemology demanded the presence of the Al Qur'an and Sunnah as the main reference and the first in discovering the truth guide. So, the hypothesis H_0 and H_1 must be referred to $W(\theta)_i$; and the equation model should have $[(\Omega, S) \rightarrow \theta]$ to find the new knowledge as the development of science, benefits for policy, empirical finding, motivation research, and integration conclusion.

Then, according to the above ECG Model, the mathematical equation model by using a multiple regression based-on the generic conceptual framework of Islamic economics can be shown in the below equation:

If $Z(\theta) = (\theta, W, \zeta)$

$$W(\theta) = (\theta, X_i, Y_i)$$

$$Z(\theta) = W(\theta) + \theta + \zeta$$

$$W(\theta) = X_1Y_1 + X_2Y_2 + X_3Y_3 + X_nY_n + \theta$$

Then $Z(\theta) = ECG = (\theta, W, \zeta) \dots\dots\dots (8)$

$$Z(\theta) = W(\theta)_n + \theta + \zeta \dots\dots\dots (9)$$

$$W(\theta)_{1-6} = W(\theta)_1 + W(\theta)_2 + W(\theta)_3 + W(\theta)_4 + W(\theta)_5 + W(\theta)_6 \dots\dots\dots (10)$$

$$W(\theta)_{1-6} = X_1Y_1 + X_2Y_2 + X_3Y_3 + X_4Y_4 + X_5Y_5 + X_6Y_6 \dots\dots\dots (10)$$

Philosophy = 'Aqiidah + Sharia + Akhlaaq

$$Y_1 = Y_{1.1}.\lambda_1 + Y_{1.2}.\lambda_2 + Y_{1.3}.\lambda_3 + \delta_1 \dots\dots\dots (11)$$

Right and Interest

$$Y_2 = Y_2.\lambda_1 + \delta_2 \dots\dots\dots(12)$$

Aim = Diin + Nafs + Maal + Nasl + 'Aql

$$Y_3 = Y_{3.1}.\lambda_1 + Y_{3.2}.\lambda_1 + Y_{3.3}.\lambda_1 + Y_{3.4}.\lambda_1 + Y_{3.5}.\lambda_1 + \delta_3 \dots\dots\dots(13)$$

Management = Khalifah + Shura

$$Y_4 = Y_{4.1}.\lambda_1 + Y_{4.2}.\lambda_1 + \delta_4 \dots\dots\dots(14)$$

Management Board = Sharia Board + Other Institutions

$$Y_5 = Y_{5.1}.\lambda_1 + Y_{5.2}.\lambda_2 + \delta_5 \dots\dots\dots(15)$$

Nature of Business

$$Y_6 = Y_{6.}.\lambda_1 + \delta_6 \dots\dots\dots(16)$$

So, we can substitute all the equation (11), (12), (13), (14), (15), (16) into the equation (10),

$$\begin{aligned} W(\theta)_{1-6} = & X_1.(Y_{1.1}.\lambda_1 + Y_{1.2}.\lambda_2 + Y_{1.3}.\lambda_3) + X_2 Y_2.\lambda_1 + X_3.(Y_{3.1}.\lambda_1 + Y_{3.2}.\lambda_1 + \\ & Y_{3.3}.\lambda_1 + Y_{3.4}.\lambda_1 + Y_{3.5}.\lambda_1) + X_4.(Y_{4.1}.\lambda_1 + Y_{4.2}.\lambda_1) \\ & + X_5.(Y_{5.1}.\lambda_1 + Y_{5.2}.\lambda_2) + X_6 Y_6.\lambda_1 + \delta \dots\dots\dots (17) \end{aligned}$$

then,

$$\begin{aligned} ECG &= Z(\theta) \\ ECG &= X_1.(Y_{1.1}.\lambda_1 + Y_{1.2}.\lambda_2 + Y_{1.3}.\lambda_3) + X_2 Y_2.\lambda_1 + X_3.(Y_{3.1}.\lambda_1 \\ &+ Y_{3.2}.\lambda_1 + Y_{3.3}.\lambda_1 + Y_{3.4}.\lambda_1 + Y_{3.5}.\lambda_1) + X_4.(Y_{4.1}.\lambda_1 + Y_{4.2}.\lambda_1) \\ &+ X_5.(Y_{5.1}.\lambda_1 + Y_{5.2}.\lambda_2) + X_6 Y_6.\lambda_1 + \delta + \theta + \zeta \dots\dots\dots (18) \end{aligned}$$

Note:

W(θ) = ECG criterion of attained levels of unity of knowledge in the *Tawhidi* unified world-system relating to specific problems and variables;

X_n = Coefficient

Y₁ = Philosophy

Y₂ = Right and Importances

Y₃ = Aim

Y₄ = Managements

Y₅ = Management Boards

Y₆ = Output Business

δ_n = Other Factors

θ = Set of knowledge of unity derived from the fundamental epistemology of (Ω, S) through discursive mappings involving conceptualization, methodology and formalism of the system upon which explanation and problem-solving depend (Exogenous Factors)

ζ = Destiny

The proposed mathematical equation of ECG is a discursive formal model develops at this first conceptual level, carrying the “meaning” of oneness of the divine law in reference to the primordial epistemology of (Ω , S). Chodhury (2007) explains that such a concept of “meaning” in “everything” is carried through the discursive medium for deriving knowledge flows (θ) arising from (Ω , S).

5. Conclusion, Implication and Limitation

This paper has shown that the generic of unity of knowledge as the universal episteme of the Islamic worldview contrast with the conventional ones in its methodology, paradigm, and conceptual framework. This generic worldview was particularized to the CG. Uniquely, in the context of corporate governance within the Islamic paradigm, it presents distinct characteristics and features in comparison with the western system as it refers as a special case of a broader decision-making theory that uses the premise of Islamic socio-scientific epistemology which is premised on the divine oneness of God.

There are some limitation of this paper. Referring to Creswell (1994), this paper also has problem to the research. The concept might be immature due to a conspicuous lack of theory and previous research. The model to capture the available theory may be inaccurate, inappropriate, incorrect, or biased. This paper is still need to explore and describe the phenomena and to develop theory. The last, this proposed model of phenomenon may not be suited to quantitative measure. But, the main mission of this paper is to contribute the knowledge development for Islamic economics.

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