

# Developing a Model for Corporate Governance and Conflict of Interest Deterrence in Shariah-based Cooperatives

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## 1.0. INTRODUCTION

Co-operatives have always been considered as economic entities with strong social responsibility towards the members in particular and the society at large. Co-operatives have contributed significantly to the economic and social development of societies and communities through their operations in a wide range of economic enterprises such as banking, credit/finance, plantations, housing, industry, consumer goods, construction, transport and services. A financial cooperative is a financial institution that is not for profit, which is owned and controlled by its members and operated for the purpose of promoting thrift, providing credit at reasonable rates, and providing other financial services to its members (Saeed and Hardy, 2013). Every member of the cooperative is the owner and each member has one vote regardless of the amount or size of the loan. Regardless of account size in the credit union, each member may run for the volunteer board of directors and cast a vote in elections. Members are meant to benefit from acceptable returns on savings, reasonable rates on loans, and fewer fees than would be typical of a conventional, profit-maximizing bank (WOCCU, 2012). Ahmad Bello (2005) states that the process of developing and sustaining a co-operative involves promoting the community spirit, identity and social organization as co-operatives play an increasingly important role worldwide in poverty reduction, facilitating job creation, economic growth and social development.

Consultative Group to Assist the Poorest (CGAP) has outlined the key challenges of governance faced by credit unions in developing countries. These include the lack of participation in decision-making structure among members. This can lead to a situation where co-operative societies dominated by elites who subsequently had abused its funds to secure their own positions. They offer these funds as loans related to their own supporters. In addition, the problem also occurs among management in which board members continue to exercise operational control even after professional managers have been appointed (CGAP, 2005).

Co-operative development agencies and sector bodies such as the World Council of Credit Unions (WOCCU) are also seeking to improve governance standards among credit unions worldwide. A series of guidelines on good practice and governance codes have been developed and suitable training programs are also available (WOCCU, 2006). WOCCU also promotes the formation of national apex bodies as a significant strategy to influence national policies relating to cooperatives seeking to improve governance of local and state entities. WOCCU also shares common concerns with CGAP on the need to improve governance standards on the co-operative board members. Both assert that transparent information which is distributed to all members create confidence and could help in decision making between members and leaders. At the same time, the level of participation in the general assembly of members should be increased (Ortega, 2006).

Different from a conventional cooperative, a Shariah-based cooperative observes Shari'ah principles. As these cooperatives offers Islamic financial products and involves in Shariah compliant investment, they are bound to observe Shariah governance structure, transparency, disclosure of information and strict compliance with shari'ah principles. Compliance with the shari'ah principles will strengthen public confidence in the credibility of the system of the Islamic Mu'amalat particularly in the cooperative movement (Samad

R. R. and Shafii Z.; 2016). Among concepts adopted are *Bay' murabahah* (cost-plus sale contract), *Bay' 'inah* (immediate sale after purchase), *tawarruq* (organised sale after purchase), *Bay' Salam* (sale of asset in the future) and *Bay' Istisna'* (sale of manufactured asset). Other than that are the profit-sharing based contract that is both types of *mudharabah* (deposit/investment), *mudharabah* financing (profit sharing) as well as *musharakah* financing (partnership) contract (Samad R. R. and Shafii Z.; 2016). In comparison to Islamic financial institutions, the adoption of Islamic finance in cooperative sector is considered new. On the governance aspects the implementations of Shariah rules in the cooperatives is still weak due to lack of expertise and Shariah guidelines. Capacity building on Shariah governance and compliance is critical to equip the main organs of cooperatives in organising their roles and responsibilities.

Due to the infancy of Shariah-based cooperative industry that needs for proper governance measures, this paper aims to discuss corporate governance in Shariah-based cooperatives in the attempt to propose a model for resolving stakeholders' conflicts of interest. Section 1 introduces the issues of governance in cooperative movement and the emergence of Shariah-based cooperatives. The rest of this paper is organised in the following manner. Section 2 provides a background to the issue of governance in Shariah-based cooperatives, this paper reviews the state of operation and growth of Shariah-based cooperatives in Malaysia, Indonesia and Thailand that hosts significant numbers of Shariah-based cooperatives. Section 3 in turn compares laws, supervision and oversight of Shariah-based cooperatives in these countries to identify respective cooperative governance measures that includes measures to deter conflict of interest in cooperative governance. Section 4 discusses the composition, role and performance framework for cooperative management to build the case for the need of clear roles of governance organs in Shariah-based cooperatives. Section 5 discusses the existing practice of performance as well as proposals for performance management framework suitable to be adopted in Shariah-based cooperatives. This is to elucidate the the role of performance management framework that provides measures that provides checks and balances to keep conflict of interest at bay. Section 6 discusses Shariah assurance framework adoptable in Shariah-based cooperatives, a vital function to ensure Shariah compliance of the institution. Section 7 concludes the paper.

## **2.0 STATE OF OPERATION AND GROWTH OF SHARIAH-BASED COOPERATIVES IN MALAYSIA, INDONESIA AND THAILAND**

The role of co-operatives as the third economic sector is becoming increasingly important in Malaysia in the present and future. The latest development strongly influenced by the development of information and communication technology (ICT) as well as the external influences such as globalization, deregulation and liberalization changes. The fundamental challenge is for the country to maintain the integrity of the co-operative identity, concept and philosophy. Co-operatives are formed with the idea of mutual co-operation.

### **2.1 GROWTH OF COOPERATIVES IN MALAYSIA**

In Malaysia, the co-operative society was first established since 1922 to protect the welfare of rural peoples. The establishment is not only to improve the wellbeing of its members but also to eradicate the poverty and act as the distribution tools of national wealth. With the aim to help its members, it is said that co-operative needs to accelerate its performance in order to transform the nation to be the high income nation by the year 2020.

The increasing number of co-operatives in Malaysia is also a good indication that people are more confident with co-operatives as a way to improve their living in the context of economic, political and environment (Yearly Financial Report of Co-operatives, 2010). The co-operative movement was not spared the 1997 financial crisis that hit Malaysia and other countries in the region (Salleh et. al., 2008). Although the economic environment was not favorable, the co-operative movement indicated merely insignificant decline in progression from 1997 to 2000 and by the end of 2005, there were 4,771 registered co-operatives having 5.685 million members, share capital amounting to RM6.849 billion and total assets worth RM34.868 billion (Department of Co-operative Development Malaysia, 2006). By December 2007, the number of co-operatives had increased to 5,170 with 6.32 million members with a share capital and assets of RM7.80 billion and RM47.4 billion respectively (Nazura & Pardis, 2013). By now, all these data is increasing from time to time although there are some issues that hold cooperative continues to grow rapidly.

Today, co-operatives performance is being influenced by the huge and complex role assigned to them in the National Co-operative Policy (NCP). Expectation placed on the co-operatives are high as they are perceived to be the third sector in the economy. They are expected to function as a vital part in reducing poverty and are given a specific place in the overall plans for the national development. It acts as an association of people who work together to achieve certain economics objectives. However, high expectation has been put on them. Cooperative is expected to play role of transforming society. In reality, the co-operative movement only contributes just slightly more than 1 percent to the GDP of Malaysia and it is targeting an increase to 5 percent contribution by 2020 (SKM, 2010).

**Table 1:** Cooperatives' Equity, Revenue and Profit in Malaysia (2014)

No	States	No of cooperatives	Members	Shares (RM million)	Assets (RM million)	Income (RM million)
1	Johor	1,151	467,114	266.20	781	542.49
2	Kedah	920	340,508	309.02	637.08	258.11
3	Kelantan	736	335,835	261.62	1,333.39	484.65
4	Melaka	452	195,903	88.56	417.70	76.38
5	Negeri Sembilan	648	205,297	106.93	311.86	137.35
6	Pahang	927	302,129	258.62	931.03	685.71
7	Perak	1,249	377,365	501.95	1,049.70	351.44
8	Perlis	175	73,874	66.80	127.63	59.12
9	Pulau Pinang	677	241,736	596.49	2,212.34	712.25
10	Sabah	1,150	338,845	125.81	678.82	246.51
11	Sarawak	917	334,649	158.13	543.68	160.71
12	Selangor	1,394	648,519	603.73	1,407.04	311.21
13	Terengganu	609	240,899	217.32	496.64	282.63
14	Wilayah Persekutuan	864	2,375,320	6,934.06	16,422.46	24,541.23
15	Head Quarters	2	931,554	2,972.81	89,437.33	6,101.18
	TOTAL	11,871	7,409,547	13,468.06	116,787.70	34,950.98

Source: Suruhanjaya Koperasi Malaysia

Saeed and Hardy (2013) commented that the cooperative is a financial institution that is not for profit, which is owned and controlled by its members and operated for the purpose of promoting thrift, providing credit at reasonable rates, and providing other financial services to its members. Every member of the cooperative is the owner and each member has one vote regardless of the amount or size of the loan. Regardless of account size in the credit union, each member may run for the volunteer board of directors and cast a vote in elections. Members are meant to benefit from acceptable returns on savings, reasonable rates on loans, and fewer fees than would be typical of a conventional, profit-maximizing bank (WOCCU, 2012).

Saeed and Hardy (2013) explore the cooperative movement and cooperative banking history. Franz Hermann and Schulze-Delitzsch established a co-operative bank in Germany in 1852. At the time of Raiffeisen's death in 1888, credit unions have spread to Italy, France, the Netherlands and Austria, among other countries. Many of the cooperative movement has been and still infused with religious or secular morality that emphasizes frugality and solidarity between all the parties involved, and the crime of usury. The same belief applies also to encourage the movement of microfinance institutions (MFIs), which Grameen Bank is the most famous.

Over time, the cooperative sector in each country has tended to become more concentrated and more integrated. Some of the cooperative banks have subsidiaries that

also companies that are listed, and sometimes a cooperative organizations have a bank which itself is organized as a limited liability company.

In general, the forming part of a cooperative movement in a country can be categorized or divided into three stages. These stages are determined by the pattern of membership of a cooperative. Thus, there are three categories of cooperatives which may be registered in most states as primary-level cooperative, secondary-level cooperative or tertiary-level cooperative. Table 2 provides the statistics of cooperatives in Malaysia according to function.

**Table 2:** Statistics on Number of Cooperatives (Functions based) from years 2012 through 2014

No.	Functions	Number of Cooperatives		
		2014	2013	2012
1.	Banking	2	2	2
2.	Credit	597	589	588
3.	Plantation	2,559	2,324	2,148
4.	Housing	217	180	159
5.	Industrial	253	225	201
6.	Consumer	4,916	4,673	4,416
7.	Construction	196	173	163
8.	Transportation	460	447	435
9.	Services	2,677	2,301	1,975
	<b>TOTAL</b>	<b>11,871</b>	<b>10,914</b>	<b>10,087</b>

Source: [www.skm.gov.my](http://www.skm.gov.my)

Table 3 shows the general statistics on cooperatives as at 2014. The consumer function has the biggest number of members in the rank. In terms of total shares, it is led by credit function while banking function has the largest total assets among the others. However, the services function declared the highest total income compared to the others.

**Table 3:** General Statistics on Cooperatives as at 2014

NO	FUNCTIONS	No of cooperatives	No of members	Total shares (RM million)	Total Assets (RM million)	Total Income (RM million)
1.	Banking	2	993,593	3,316.28	90,632.63	6,093.65
2.	Credit	597	1,338,057	5,606.84	11,945.73	1,878.66
3.	Plantation	2,553	744,863	604.86	2,449.65	2,823.13

4.	Housing	217	154,944	218.42	1,032.35	530.45
5.	Industrial	253	18,155	11.04	78.77	35.97
6.	Consumer	4,916	2,748,160	335.87	1,654.72	1,126.75
7.	Construction	196	130,614	59.61	414.23	87.47
8.	Transportation	460	149,273	67.18	323.30	700.67
9.	Services	2,677	1,131,888	3,247.96	8,257.06	21,674.21
	<b>TOTAL</b>	<b>11,871</b>	<b>7,409,547</b>	<b>13,468.06</b>	<b>116,787.70</b>	<b>34,950.98</b>

Source: [www.skm.gov.my](http://www.skm.gov.my)

## 2.2 THE GROWTH OF COOPERATIVES IN INDONESIA

Cooperatives are formed with the idea of mutual cooperation. Due to the features, cooperative has the potential to solve the issue of poverty alleviation and improvement of income distribution, which currently is a central focus of Indonesian government's economic policy making.

The cooperative in Indonesia is considered as one of the largest public society organizations as well as social enterprises with great potential in rural development and employment creation. According to International Labour Organization (2012) cooperatives also play an important role in economic development particularly rural development worldwide, including Indonesia. It is estimated that 50 per cent of global agricultural output is marketed through cooperatives.

According to the Indonesian Ministry of cooperatives and SMEs, the number of active cooperatives is 147,249 out of 209,488 per December 2014. Most of these cooperatives (around 70 per cent) are located in rural areas. The cooperative movement in Indonesia is considered as one of the largest domestic society organizations as well as social enterprises with great potential in rural development and employment creation (ILO, 2012). Definition of cooperatives in Indonesia is described in Act No. 25 year 1992 on cooperatives which state that the cooperative is a business entity consisting of persons or legal entities based on cooperative principles and the principle of brotherhood. In 2007, the ministry also issued the act no.39 on the supervisory guidelines. The act states that the Shariah-based cooperatives must provide regular auditable financial reporting and show the compliance on Shariah-regulations. According to Indonesian cooperative act, the elements of cooperatives can be described as follows:

- 1) Cooperative is a business entity.
- 2) Cooperative may be established by a person or legal entity as well as a member cooperative.
- 3) Cooperative is managed based on the principles of cooperatives.



4) Cooperative is managed based on the principle of brotherhood.

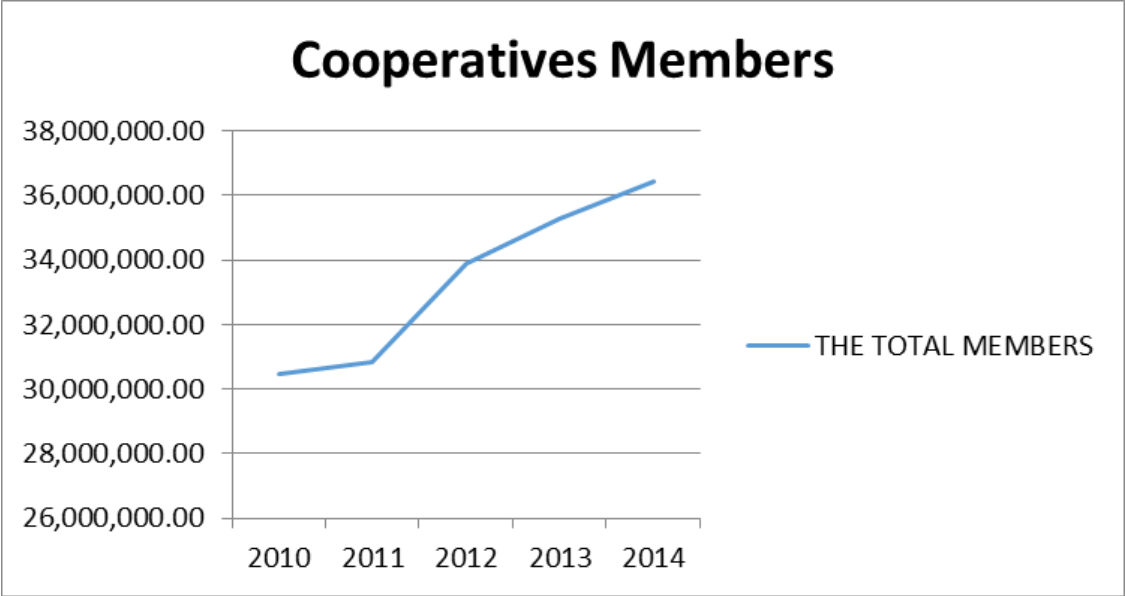
The development of Indonesian cooperatives shows a significant improvement, but the quality is considered weak. It requires a strong commitment to build a cooperative being able to survive. Good cooperative governance must be in place and cooperative values must be implemented to survive and to provide benefits to its members. The development of cooperatives in Indonesia can be shown in the following table.

**Table 4:** The Growth of Cooperatives in Indonesia

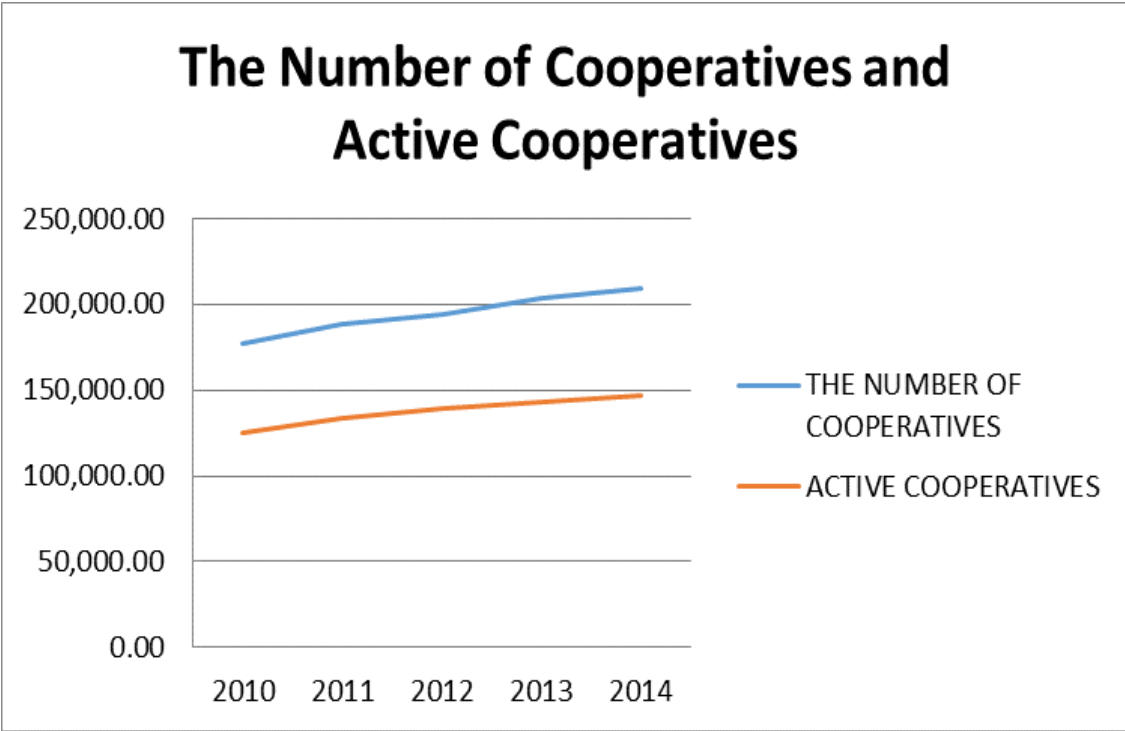
	2014	2013	2012	2011	2010
The number of cooperatives	209,488	203,701	194,295	188,181	177,482
The number of active cooperatives	147,249	143,117	139,321	133,666	124,855
The members	36,443,953	35,258,176	33,869,439	30,849,913	30,461,121
The employees	530,830	438,541	393,502	342,896	326,718.00
The equity(IDR)	105,800 T	89.536 T	51.422 T	35.794 T	30.102 T
The equity-external (IDR)	94,861 T	80.840 T	51.403 T	39.689 T	34.687 T
Revenue (IDR)	189,858 T	125.584 T	119.182 T	95.062 T	76.822 T
The distributable income for members	14,898 T	8.110 T	6.661 T	6.336 T	5.622 T

Source: Annual statement of Ministry of Cooperatives and SMEs 2010, 2011, 2012, 2013 and 2014

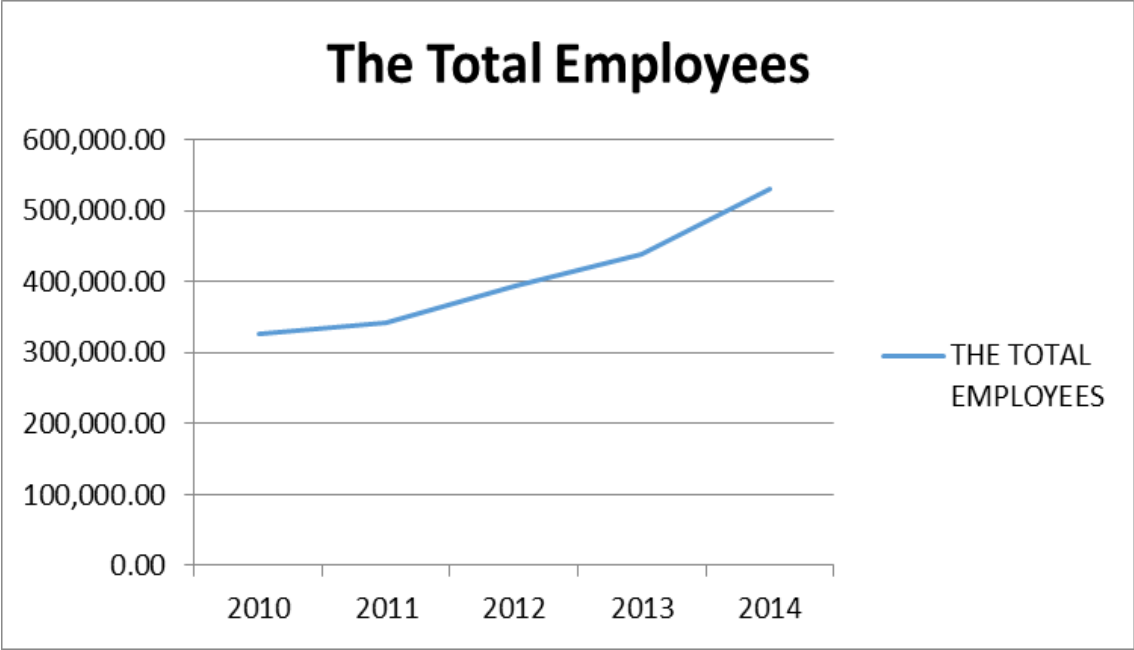
According to the table above, it describes the growth of Indonesian cooperatives in the last five years. The number of cooperatives increased approximately 5% year every year. The total members also increased around one million members in a year. In terms of capital structure (equity and external equity), the table shows a significant increase. The steep growth of revenues indicates the better business operation of Indonesian cooperatives. The following charts describe the growth each components in a more detailed picture. Figure 1 to 5 illustrate the growth of numbers of cooperative members, number of cooperatives, total employees and growth of cooperatives by types.



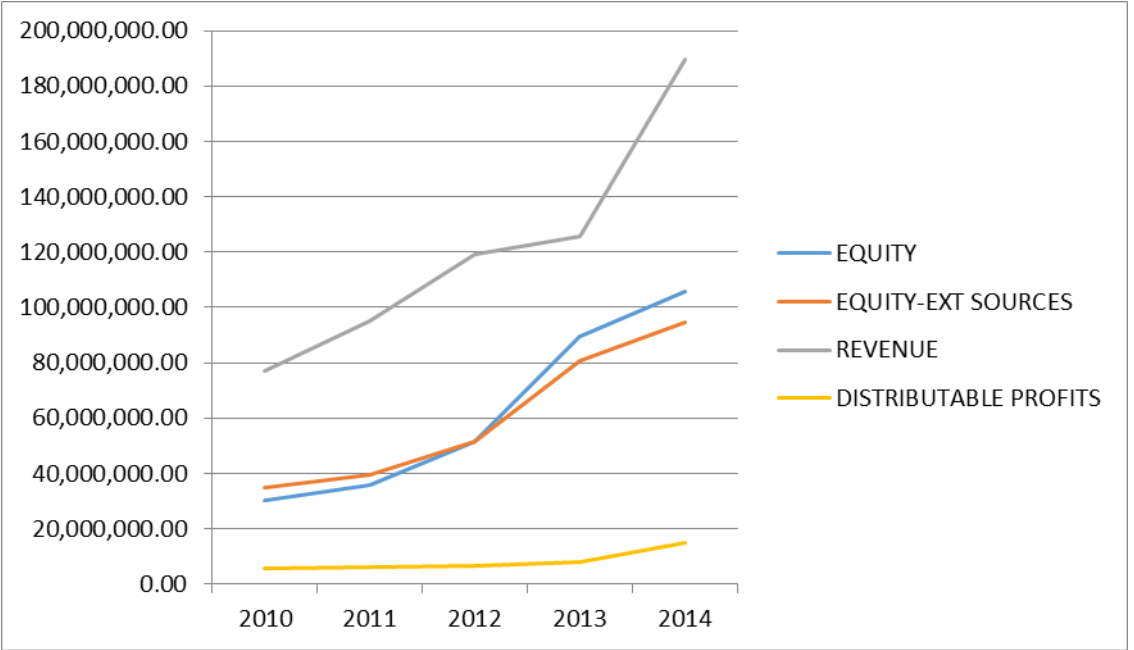
**Figure 1:** The growth of cooperative members



**Figure 2:** The Number of Cooperatives



**Figure 3:** Total employes in the Cooperative Sector



**Figure 4:** The growth of Cooperative by Type

**2.2.1 BMT and Shariah Cooperatives**

Indonesia has various types of cooperatives including conventional cooperatives, Baitul Maal wa Tamwil and also Shariah cooperatives. Baitul Maal wat Tamwil (BMT) is a Micro Finance Institutions (MFIs), which operates based on the principles of Shari'ah. BMT has two main functions. Bait al Maal which etymologically is defined as a financial institution

that manages funds activities for social purposes and the source of the funds obtained from zakat, infaq, and sadaqah or other lawful sources. Bait at Tamwil is an institution conducting business and investments in improving for commercial purposes. BMT is slightly different from Shariah cooperatives or Islamic financial cooperatives (Koperasi Jasa Keuangan Syariah). Shariah cooperatives consists of one institution or one role only (as a cooperative itself) while BMT is an institution with two roles (Bait al Maal and Bait at Tamwil). When a Shariah cooperative has the dual roles, it can be considered as BMT. Both Shariah cooperatives and BMTs run the business in accordance with Shariah rules and requirements.

According to the Center for the Study and Development of Small Enterprises, Shariah cooperatives and BMT have particular objectives as follows:

- a) To improve and develop national economies, especially SMEs
- b) To boost business productivity by providing financing to small entrepreneurs
- c) To help small and medium entrepreneurs away from the interest system
- d) To improve the economic empowerment of Muslims.

The development of BMT in Indonesia is not supported by a specific regulation. BMT has unique characteristics compared to other types of existing cooperatives, because BMT has both commercial and social purposes. So far, BMT is considered as one type of cooperatives. There is no adequate legal support for the BMT operation in Indonesia. Therefore some BMT adopt the legal form of a cooperative, but it is still an option not a requirement. BMT also refers to the Act No. 25 of 1992 concerning Cooperatives Act No. 17 of 2012. On the other hand, in practice BMT operations also refers to the regulation of Ministry of Cooperatives and Small and Medium Enterprises No. 91/Kep/M.KUKM/IX/2004 on Islamic Financial Cooperatives (Shariah cooperatives).

BMT / Shariah cooperative is similar with cooperatives in terms of the legal status of the entity. On the other hand BMT is also different from cooperatives in operational aspect. Cooperatives are based on conventional operations while BMT is in line with Sharia requirements. BMT and Shariah cooperatives have the same business operations. Besides that, the differences of BMT and conventional cooperatives are also in terms of the organizational structure and cooperatives capital. BMT and Shariah cooperatives have Sharia Supervisory Board and the initial capital supported by Islamic banks. Conventional cooperatives get the initial capital support from Government Bank.

In terms of business operations, cooperatives take advantage by way of interest rate system, while Shariah cooperatives and Baitul Maal wa Tamwil are based on profit sharing system. In terms of the distribution of funds, cooperatives have one contract only, which is lending and borrowing. BMT and Shariah cooperatives offer some contracts such as the cooperation contract, purchase, lease and loan in line with Shariah requirements. The following table displays more the differences between cooperatives and Shariah cooperatives/BMT:

**Table 5:**The differences of cooperatives and Shariah cooperatives / BMTs

Aspects	Cooperatives	Shariah cooperatives and BMT
Organizational structure	Supervisory board	Shariah supervisory board
Equity	Initial equity is supported by and deposited to government bank(s)	Initial equity is supported by and deposited to Islamic bank(s)
The legislation of establishment	After the final meeting, the team meet the notary for the establishment of cooperative	After the final meeting, the team meet PINBUK as the initiator of BMTs before the notary for the establishment of cooperative
Basic concept of business operations	Interest rate	Profit sharing or revenue sharing
Funding	Savings Current accounts	Wadiah Mudharabah
Distribution of fund	Lending	Qard Mudharabah Musyarakah Murabahah Salam Istisna Ijarah
Social role	-	Collecting and distributing Zakah, Infaq, Sadaqah fund from the members

Source: Ma'wa (2013), Act no 17 of 2012 on Cooperatives

### 2.2.2 THE PRODUCTS AND SERVICES OF SHARIAH COOPERATIVES AND BMTs

BMTs and Shariah cooperatives provides some following financial services and products:

- a. Saving Deposits Wadiah Yad-Dhamanah
- b. This type of deposits can be used by Shariah Cooperatives or BMTs for business activities. In return, BMTs or Shariah cooperatives can give bonus or compensation in accordance with the policies and the ability of the cooperative.
- c. Investment (Mudharaba)  
The savings of cooperatives' members will be treated as investment by providing financing for other members in a professional manner based on profit sharing ratio agreed.
- d. Murabahah financing  
Murabahah is defined as the sale of goods at cost plus mark up. The purchaser should be informed of his cost of purchase and the profit amount.
- e. Ijarah is a type of leasing
- f. Salam and Istisna financing is a purchase order contract.

- g. Qard Hasan is a financing provided by the cooperatives / BMTs for the members in need. There is no profit/loss sharing, neither profit margin imposed to the financing.

### **2.3 THE GROWTH OF COOPERATIVES IN THAILAND**

There are 37 cooperatives operating in Thailand with the total assets amounted 2,000 million THB. The cooperatives are serving around 7 million of Muslim Thais. Islamic cooperatives are rapidly growing in populous Muslim areas in Southern Thailand.

The cooperatives duly registered under the Cooperative Act 2511 (2542) being co-founder at the initial stage. The objectives of the operation of cooperatives are to create unity in the implementation of strict Islamic principles and to create a network of support and cooperation and exchange of academic experiences to function business.

Islamic cooperative mobilises savings and financial services and provides avenues for investments that are Shariah-compliant for grass-roots society consists of farmers and small economic groups. Islamic cooperatives adopt similar albeit restricted types of Islamic financial constructs to develop savings and investment products. Instruments mobilized so far are murabahah (cost plus financing) and musharakah (joint venture partnership) and mudharabah (profit sharing) deposits for savings mobilization.

Sakofah Saving is one of the biggest four cooperatives in Thailand, operating in Krabi. Other cooperatives are Siddik in Hat Yai, Ibn Affan in Fattani, and Ibn Auf in Satun. Sakofah Saving cooperative was established in 1995, regulated under the cooperative Ministry. The establishment of the cooperative was the fruit of efforts of Mr. Murod and some of his colleagues during to the time, with the aim to cater the financial need of Muslim community in Krabi. The organizational structure consists of supervisory board, director, secretary, managers, and staffs. Regarding the existence of Shariah committee, Sakofah does not have its own Shariah Committee. In the case that Sakofah needs Shariah advisory, it has to refer to the Shariah Committee that was established by the Islamic Cooperative Network, which Sakofah is affiliated, along with other cooperatives mentioned in other districts in Thailand.

Sakofah publishes its annual report in June annually. When it was first established, it had less than 200 members. As in June 2015, the members amounted 8,224. Unfortunately, the members of the co-op has dropped as compared to the previous month. It is because some of the members cannot be contacted and the co-op has to delist the number of members who are not committed.

Sakofah performs its role as an intermediary, collecting fund from the surplus unit and distributing funds to the units which need some financing. Sakofah collects the funds through two options; both membership and non-membership. The members can invest their funds in two modes of investments namely musharakah and mudharabah. The members must pay a minimum saving amounted 200 THB per month while non-members must deposit 150 THB for the first payment. For members with the minimum requirement

of saving 200 THB per month, they will get around 100 THB per month. However, they cannot withdraw it anytime since it will be accumulated until they reach 65 years old.

The saving products offered by Sakofah are Musharakah, Mudarabah, Wadiah. From the collected funds, Sakofah makes investment and provides financing for customers. The percentage of investment and financing is currently at the ratio of 50:50 respectively.

Mostly, Mudharabah and Musyarakah deals with Palm Oil and Real Estate projects. For Palm Oil, Sakofah will share the profit 80:20 for customers and Sakofah respectively. The profit or dividend for Mudarabah will be paid every 3 month. For Real estate, 5.5% will be given per year. The dividend will be paid monthly basis and in 24 months period for special project. Other project that the co-op should do is Hotel. For instance, they need 10 million, then Sakofah will collect money from members and do the investment.

There are levels for members who invest in Musharakah:

- 6 – 36 months: Bronze
- 37 – 60 months: Silver
- 61 – 99 months: Gold
- 100 months plus: Diamond

They will be receiving the dividend accordingly. So far, Musyarakah fund has reached more or less 483 million THB.

Sakofah has 5 staffs from HQ to evaluate and analyse the feasibility of investment. It has duty like so called “investment committee”. The committee does not really have procedural steps to select the promising investments. If the branches requested the staff to do the assessment, HQ will send the staff. However, the expert evaluator will be outsourced if the project is too huge.

How Sakofah distributes the funds? The only mode of financing is Murabahah. For example they have a product amounted 10 million and they sell it for 15 million. The profit of 5 million will be divided to members. Murabahah will cover all halal products including agriculture as well as productive sectors (livestock ranch, farming). The amount of Murabahah plafond range from 1000 THB to 1 million THB. Sakofah will take 10% margin from individual consumption and 12% margin for business purpose. Murabahah products mostly cover the following products:

- Housing
- House repair
- Refinancing house from conventional banks
- Refinancing vehicles from conventional banks
- Land
- Refinancing land from conventional banks
- Daily needs for members

Besides performing its role as an intermediary, Sakofah also has performed its social role. It has particularly unique products (Qard hasan and hibah/free gift). Sakofah co-op will provide hibah for members, including maternity amounted 1,000 THB and marriage amounted 1,000 THB. Sakofah also provides Qard Hasan for Mahar (dowry).

In order to ensure sustainability of the cooperative, the Board and Management of Sakofah needs to develop its products to enhance its performance as well as to provide for the needs of customers. Sakofah is also facing a problem which is “not enough” money to maintain its activities. It should not be merely offering Murabahah, but should provide other modes of financing. In addition Shariah governance of Shariah-based cooperatives in Thailand is needed to ensure proper implementation of Islamic principles in their operation. At the moment, central Shariah advisory service is provided at the Islamic cooperative network established to provide an integrated operation among the cooperatives. However, little initiatives are performed on Shariah assurance that verifies Shariah implementations.

### **3.0 COOPERATIVE GOVERNANCE AND CONFLICT OF INTEREST DETERRENCE: COMPARATIVE ANALYSIS ON LAWS, SUPERVISION AND OVERSIGHT OF SHARIAH-BASED COOPERATIVES**

At the international level, the Cooperative Governance Guideline is introduced to underline the general principles and minimum benchmark as well as governance requirement for the cooperatives as for the reference and continuous practice in their organization. A good governance should involve all parties, namely members as the owner, the management of the cooperative that handles transactions and the Board as a designer and advisor to management for the owners in an effort to improve the performance of a cooperative.

The central challenge for co-operative governance remains how to balance the principle of democratic control and retain the imperative of professional management. The continuing and purposeful education of membership is vital to the development of a successful co-operative. In addition, corporate governance measures for primary co-operatives need to address the following issues (Taimni, 2001);

- i. An open and easily understandable election procedure; contested elections to the board are desirable and should be encouraged;
- ii. Elected office bearers should be made fully aware of their duties and responsibilities through education and training, and involvement in the management of their co-operative;
- iii. Clear cut division of legal responsibilities between the board of directors and paid managers should be set in bylaws if not already provided for in the law;
- iv. Internal and external audit should be conducted on a regular basis and the audit reports should be thoroughly evaluated by the board;
- v. New ways should be developed and introduced of information, consultation and control so as to increase members’ participation;
- vi. A ‘co-operative code of best practices’ with the objective of helping a co-operative redefine the duties and responsibilities of the governing bodies and management, to make governing and control issues more transparent.

Thus, the co-operative movement should be prepared to address the issues, challenges and external influence in maintaining the identity, concept, philosophy and co-operative



practices. Intellectual and human capital as well as good management of the co-operative movement promotes a strong compliance (Yeop Husin, 2007).

### **3.1 Law, Court Monitoring and Supervision and Oversight: The Case of Malaysian Cooperatives**

Since the cooperative movement was first introduced in Malaysia approximately eighty five years ago, there is no doubt that it has had a positive impact on Malaysia's economic development (Manap and Tehrani, 2014). The characteristic of being community-centered has rendered cooperatives as valuable institutions in economic development in the society. This part will describe the cooperative legislation in Malaysia.

#### **3.1.1 Dedicated law on cooperative in Malaysia**

The cooperative legislation which has been governing cooperative movements since before the Malaysian independence was the Cooperative Act 1948. It was reviewed and was found to be an instrument not quite efficient for constitution and control purposes. Hence, it had been replaced by the Cooperative Act 1993 which unifies and consolidates the various legislations governing all cooperatives in Malaysia (Othman et al, 2013). The cooperative regulations 1995 was established to strengthen the law and give effect to the principles and provisions of the Act. The Act and Regulations 1995 were designed to promote good management practices, enhance member empowerment, strengthen the role of the Department, allow for the establishment of cooperative subsidiaries to enhance their role in the economy, and to enable cooperatives to allocate portions of their profit to fund projects for the benefit of the community (Manap and Tehrani,2014).

The regulations 1995 influence main features of promoting good management practices, enhancing member empowerment, encouraging the setting up of subsidiaries and enabling cooperatives to keep aside some portion of profit for the benefit and betterment of the community (Othman et al, 2013). Later on, a few of amendments were done to update the act on cooperative. The Cooperative Act 1993 amended with 1995 (Act 928), was then amended again with 1996 (Act 963), 2001 (Act A1128) and 2007 (Act A1297) (Othman & Kari (2008); Othman et al (2013); Manap and Tehrani (2014)) . During the development of cooperative, an agency, known as the Malaysia Cooperative Societies Commission (MCC) was established to monitor and regulate cooperative movements. The latest Cooperative Act 2007 (Act A1297) was stipulated to promote cooperative values of trustworthiness, transparency and honesty within the cooperative society development. Subsequently, several guidelines were published by the MCC to strengthen the management and governance of cooperatives. The guidelines issued in 2010 are as follows:

- i. GP8: Guidelines on accounting for grants/assistance;
- ii. GP9: Guidelines on collection of special savings, deposits or loans received;
- iii. GP10: Guidelines on special investment scheme;
- iv. GP11: Guidelines on cooperative conducting banking activities;
- v. GP12: Guidelines on the establishment of cooperatives; and
- vi. GP13: Guidelines on ethics of candidates of the board member of the cooperative.

The purpose of enforcing these guidelines and regulations is to improve the efficiency of cooperative governance and to enhance the awareness of ethical conduct among cooperative officers so that the interest of the members and the public will be secured. Other than that, it also aims to promote transparency and better governance of cooperatives.

The improvement of cooperatives in Malaysia is supported by several government and non-government agencies (Othman & Kari, 2008).

- a. The Ministry of Entrepreneur and Cooperative Development (MeCD)  
This agency is responsible for coordinating the development of entrepreneurs in Malaysia. It provides entrepreneurial training and development programmes to existing micro, small and new entrepreneurs. It is also responsible for the Malaysian cooperative movement growth and MCC registers, audits accounts, advises, motivates, develops and executes the Cooperative Law.
- b. The National Cooperative Organization of Malaysia (ANGKASA).  
ANGKASA is recognized by the government as the national apex body representing the cooperative movement in Malaysia. Its function is to promote the cooperative ideology, provides member education and advisory services, publishes cooperative literature as well as represents the cooperative movement in national and international matters
- c. The Cooperative College of Malaysia (CCM).  
The college was established in 1956 and is under the MeCD. The College was stabilized in 1968 with the passing of the Cooperative College (Incorporation) Act 1968. This is the only tertiary institution in Malaysia providing cooperative education. It provides training and education to the cooperative movement in Malaysia. It also publishes, conducts research on cooperative activities and provides advisory services to cooperatives.
- d. Federal Land Consolidation Authority (FELCRA), Federal Land Development Authority (FELDA) and the Rubber Industries Small Holders Development (RISDA)  
These organizations are in charge of land development and improving the livelihood of the rural population. The government encourages the setting up of cooperatives in these land schemes with the main objective to encourage co-operation amongst the settlers and to improve their socio-economic condition.
- e. The Farmers' Organization Authority (FOA)  
It was set up in 1973 to undertake the supervision of all agro-based cooperatives. The Fisheries Development Authority (FDA) was established by the government in 1971 under the Malaysia Fisheries Development Authority Act 1971. Both authorities are under the Ministry of Agriculture and Agro based Industries. FDA is responsible for the registration, monitoring and the fishermen's cooperatives and fishermen's associations.

### **3.1.2 Shariah Advisory of Shariah-Based Cooperatives in Malaysia**

The increasing number of cooperatives in Malaysia is a good indication that people are more confident with cooperatives as a way to improve their living in the context of economic, political and environment (Financial Report of Cooperatives, 2010). As such, it

is very important to ensure a good conduct is practicing in the organization for its sustainability.

Shariah is the basis of business practices and Islamic finance where adherence to Islamic tenets, principles and conditions specified in Shariah is the main objective. Compliance with the Shariah principles will strengthen public confidence in the credibility of the system of the Islamic Muamalat particularly in the cooperative movement.

The Malaysian Cooperative Commission (EC) as a regulatory agency of the cooperative movement has always given priority to all efforts which could ensure the overall business and operations of the cooperative activities are in line with Shariah principles. In order to achieve this goal, two levels of Shariah governance need to be established - the Shariah Advisory Body on the Commission and the Committee Shariah in the cooperative.

In this regard, the Commission has authority under the Cooperative Commission Malaysia Act 2007 to establish the Shariah Advisory Body of Cooperative Commission Malaysia (BPS-SKM) for regulating cooperative business activities.

The guidelines issued under section 86B Cooperative Societies Act 1993 (the Act) to regulate cooperatives doing business or compliant activity, which include:

- (a) compliance with the requirements of Shariah; and
- (b) Cooperative Shariah governance

BPS-SKM will be helping to increase public confidence in the cooperative movement. There is also a need to establish a relationship between BPS-SKM with Shariah bodies established within the cooperative. As such, Shariah bodies should be coordinated at the level of society and renamed the Shariah Committee of the cooperative and the Committee will serve as a complement to the BPS-SKM. Table 6 presents the differences between a full Shariah cooperative and product based cooperative.

**Table 6:** Differences between Shariah-based cooperative and Product-based Cooperative

	<b>Activities / Requirement</b>	<b>Full Shariah Cooperative</b>	<b>Product Based Cooperative</b>
1.	Shariah Recognition Certificate	√	X
2.	Approval on Shariah Compliance Product: <ul style="list-style-type: none"> <li>• Current product</li> <li>• New product</li> </ul>	√	√
3.	Yearly Report on Shariah Compliance	√	√
4.	Requirement on Appointment of Shariah Board	√	√
5.	Report on Shariah Board of Cooperative: <ul style="list-style-type: none"> <li>• Appointment</li> <li>• Dismissal</li> <li>• Designation</li> </ul>	√	√
6.	Accounting Disclosure	√	√

For normal cooperative, which only produce certain Shariah product without involving the business or activities fully compliant shall obtain the approval of compliance with Shariah products Commission. The accounting system should be maintained and cooperatives reported for Shariah products separately.

Cooperatives are required to appoint at least one officer for ensure business or activity is carried out in compliance with Shariah. This officer must have at least a Diploma in Islamic Finance or Fiqh and Usul al-Mua'malat al-Fiqh, or an officer experienced at least three years in the financial industry or Islamic business.

Shariah Committee shall be appointed by the Board of the cooperative. This may be done through establishment of the internal Shariah subject to conditions and qualifications in Annex II; the appointment of recognized external Shariah Committee such as IBFIM (Islamic Banking and Finance Institute Malaysia) and ISRA (International Shari'ah Research Academy for Islamic Finance); or Shariah Committee of a cooperative group.

The Board have to confirm that the Shariah Committee understands their fiduciary responsibility in carrying out its duties. The Board also Shariah Committee shall monitor performance through periodic reports and results of meetings that is carried out. Furthermore, the Shariah Committee should be sensitive and responsible for all decisions, views and opinions relating to the Shariah cooperative affairs. It should identify issues which require attention and propose corrective measures, if necessary. The Shariah Committee shall report directly to the Board cooperative and frequently informed the Board on matters related Shariah. This reflects the status of Shariah Committee as an independent body.

The Shariah Committee shall consist of at least three members where the criteria of the Shariah Committee is as follows:

- i. Honesty, reputation and personal integrity - someone must have personal benefits such as honesty, integrity, diligence and fairness of decision;
- ii. Capacity and competence - someone must have appropriate skills, experience, abilities and commitment to responsibilities; and
- iii. Financial integrity - someone must take care of dependents or its financial position prudently.

The duties and responsibilities of the Shariah Committee as underlined in GP27 are as follows:

1. Responsibility and Accountability

Shariah Committee in carrying out its duties and responsibilities shall be responsible for all decisions and Shariah opinions provided by them.

2. To advise the Board and Cooperatives

Shariah Committee shall advise the Board and provide input to society on Shariah matters to ensure cooperative comply with Shariah principles at all times.

3. To endorse Shariah Policies and Procedures

Shariah Committee shall recommend policies and procedures compliant provided by the cooperatives and ensure that the content is consistent with the Shariah.

#### 4. Recognizing and Confirming Documents

To ensure that the products comply with Shariah principles of cooperatives, the Committee Shariah shall certify and validate:

- (a) the terms and conditions contained within the form, contract, agreement or other legal documentation used in the implementation transactions; and
- (b) product manuals, marketing advertisements, sales illustrations and brochures used to describe produk.

#### 5. Assist Stakeholders on Shariah Affairs

Parties associated with the cooperative such as lawyers, auditors or consultants can get advice on matters relating to Shariah from the Shariah Committee.

#### 6. Advice on Matters to be referred to the Shariah Advisory Body - Cooperative Commission of Malaysia (BPS-SKM).

Shariah committee may advise the cooperative to negotiate with Shariah Advisory Body of the Cooperative Commission of Malaysia (BPS-SKM) on Shariah matters unresolved.

#### 7. Provide a Written Shariah Opinion

Shariah Committee shall prepare a written Shariah opinion where the cooperative will be referring to the BPS-SKM for further discussions or, where the cooperative is applying to the Commission for approval of new products

### **3.2 Law, Court Monitoring and Supervision and Oversight: The Case of Indonesian Cooperatives**

The practice of cooperatives in Indonesian society had begun years before 1945. However, in 1945 after the independence of the Republic of Indonesia, the cooperative spirit revived. On 11-14 July 1947, the first Indonesian Cooperative Congress was held in Tasikmalaya, West Java. That congress successfully formed Indonesian Central Cooperative Organization of (Sentral Organisasi Koperasi Rakyat Indonesia - SOKRI) which later became the Indonesian Cooperatives Council (Dewan Koperasi Indonesia - DEKOPIN). The congress also decided that July 12 as the Cooperatives day and it established the principle of mutual assistance as the principle of cooperative. Muhammad Hatta as Vice President that time had a big role in mobilizing and developing cooperatives in Indonesia. Therefore, the second congress in Bandung in 1953 entitled Muhammad Hatta as the father of Indonesian cooperatives. Since then the cooperative movement consolidated the ideological and organizational purposes. Especially after Indonesia became a member of the International Cooperative Alliance (ICA) in 1956.

#### **3.2.1 Governance in Islamic cooperatives in Indonesia**

In 1949 the Indonesian government ammended the Act 91 of 1927 with Act No. 179 of 1949 which is essentially the interpretation of Law No. 21 of 1927. In 1958 the government issued Act No. 79 of 1958 and abolished the Act No. 21. In 1959 the government issued the regulations No.60 of 1959 to adjust the Act No. 79 of 1958. In 1965 the government changed the PP 60 of 1959 with Act No. 14, 1965. In 1967 the government issued Act No. 12 of 1967 on the principles of cooperatives. In 1992 the government abolished the Act

No. 12, 1967 because it was considered no longer relevant and issued Act No. 25 of 1992 on cooperatives. The recent amendment is Act No. 17 of 2012 on cooperatives.

The development of cooperatives in Indonesia is supported by several agencies as follows:

- a. Ministry of Cooperatives and SMEs  
It has a duty to assist the president in formulating policies in the field of Cooperative and Small and Medium Enterprises. This ministry deals with the drafting and issuance of government policy regarding cooperatives and small and medium businesses. It also responsible for coordinating and improving the integration of plans and programs, monitoring, and conducting regular analysis and evaluation.
- b. Institut Koperasi Indonesia (IKOPIN)  
It is a private college established and supervised by Yayasan Pendidikan Koperasi. Ikopin has a vision to become the best university in preparing cadres of cooperatives and entrepreneurs.
- c. Otoritas Jasa Keuangan – OJK (Financial Services Authority)  
It is an Indonesian government agency which regulate the Islamic financial sectors The OJK is an autonomous agency designed to be free from any interference, having functions, duties, and powers to regulate, supervise, inspect, and investigate. Regarding to cooperatives, OJK has an important role on the supervision of the certain Islamic financial cooperatives.
- d. PINBUK – Pusat Inkubasi Bisnis Usaha Kecil (Centre of Micro Business Incubation)  
It is an institution that contribute to build and develop Baitul Maal wat Tamwil (BMT) in Indonesia. BMT existence already spread almost all over Indonesia. BMT and Shariah cooperatives are expected to finance the entire local community and small entrepreneurs.

Act No. 17 of 2012 on Cooperatives: The Indonesian Regulations states states that the development and empowerment of cooperatives in any policy should reflects the values and principles of cooperatives. In general, the principles of cooperatives are described as follows:

- a. Cooperative membership is voluntary
- b. Supervision by the members conducted democratically
- c. Members actively participate in the economic activities of cooperatives
- d. Cooperatives are autonomous enterprises and independent
- e. Cooperatives provide education and training for Members, Trustees, the Board, and
- f. employees, as well as inform the public about the identity, and activity.
- g. Cooperatives serve their members are primed and strengthen the cooperative movement by working together
- h. Cooperatives work for the sustainable development for the environment and society through
- i. policies agreed by the members

The development of BMT in Indonesia is not supported by a specific regulation. BMT has unique characteristics compared to other types of existing cooperatives, because BMT

has both commercial and social purposes. So far, BMT is considered as one type of cooperatives. There is no adequate legal support for the BMT operation in Indonesia. Therefore some BMT adopt the legal form of a cooperative, but it is still an option not a requirement. BMT also refers to the Act No. 25 of 1992 concerning Cooperatives Act No. 17 of 2012. On the other hand, in practice BMT operations also refers to the regulation of Ministry of Cooperatives and Small and Medium Enterprises No. 91/Kep/M.KUKM/IX/2004 on Islamic Financial Cooperatives (Shariah cooperatives).

Indonesia has various types of cooperatives including conventional cooperatives, Baitul Maal wa Tamwil and also Shariah cooperatives. Baitul Maal wat Tamwil (BMT) is a Micro Finance Institutions (MFIs), which operates based on the principles of Shari'ah. BMT has two main functions. Bait al Maal which etymologically is defined as a financial institution that manages funds activities for social purposes and the source of the funds obtained from zakat, infaq, and sadaqah or other lawful sources. Bait at Tamwil is an institution conducting business and investments in improving for commercial purposes. BMT is slightly different from Shariah cooperatives or Islamic financial cooperatives (Koperasi Jasa Keuangan Syariah). Shariah cooperatives consists of one institution or one role only (as a cooperative itself) while BMT is an institution with two roles (Bait al Maal and Bait at Tamwil). When a Shariah cooperative has the dual roles, it can be considered as BMT. Both Shariah cooperatives and BMTs run the business in accordance with Shariah rules and requirements.

### **3.2.2 Central Supervisory Authority for Cooperative**

In Indonesia, the cooperatives and the Islamic Financial Cooperative (Koperasi Jasa Keuangan Syariah - KJKS) will not be supervised under the Financial Services Authority (Otoritas Jasa Keuangan - OJK). These two types of cooperatives will be supervised by the Ministry of Cooperatives and Small and Medium Enterprises.

There are two overarching regulation of microfinance institutions namely the Cooperative Act No. 17 of 2012 and Act No. 01 Year 2013 on Micro Finance Institutions. The existence of the two regulations is interrelated. Based on the two regulations above, the legal entity of micro finance can be in two forms, either cooperatives or sole proprietorship. If the legal status is a cooperative, so it will be supervised by the Ministry of Cooperatives and Small and Medium Enterprises. If a legal entity is a sole proprietorship, it will be supervised by the Financial Service Authority.

The existence of the cooperative cannot be underestimated despite the competition among financial institutions. Because, cooperatives are the institutions that people can rely on when they are not able to obtain financing from commercial banks. Therefore, the Ministry of Cooperative and SMEs continues to work for the cooperatives to make them the largest microfinance institutions in Indonesia. According to the ministry of cooperatives and SMEs, micro, small and medium enterprises in Indonesia amounted to 98.5% or 45 million enterprises. They are not bankable and feasible. Therefore cooperatives and Islamic financial cooperatives have are the most possible alternative in supporting and strengthening capital structure of those SMEs.

The Ministry of Cooperatives and Small and Medium Enterprises has noticed the big role of cooperatives and Islamic financial. Therefore the ministry will continue to improve

cooperatives to provide best services to its members. To support it, the ministry has determined various policies including retrofitting capital, marketing, regulatory, human resources and technology development.

Regarding Islamic financial cooperatives, in 2007 the ministry of cooperatives and SMEs issued regulations No. 35.3/Per/M.KUKM/X/2007 on the soundness of Islamic financial cooperatives and No. 39/Per/M.KUKM/XII/2007 on the supervision of Islamic Financial Cooperatives.

According to the regulations, Koperasi Jasa Keuangan Syariah (KJKS) / Unit Jasa Keuangan Syariah (UJKS) cooperatives should assess management aspects which cover general management itself, institutional matters, capital and equity management, assets management and liquidity management to ensure the soundness of the organization. The KJKS/UJKS cooperatives should ensure that the level of soundness would not decrease due to the violations of the internal and external policies and UJKS managers have not been given full authority to manage the business.

Referring to the supervisory function, supervision is defined as an activity of coaching, monitoring, inspecting, and assessing cooperative's soundness to ensure that by Islamic cooperative are run based on Shariah principles and maintain the trust of stakeholders. The cooperatives should has Internal Control System as a policy and procedure which is run by the supervisor, the board and management of KJKS and UJKS cooperative to provide reasonable assurance of the reliability of financial statement, and also the compliance with laws and regulations in supporting the effectiveness and efficiency of operations.

Supervisory function should control and ensure that KJKS and UJKS cooperative carrying out the activities in accordance with applicable laws and regulations. It should be able to improve the image and credibility of KJKS and UJKS as financial institutions being able to manage funds from members, prospective members, other cooperatives and or its members based on the cooperative principles.

### **3.2.3 Advisory On Shariah Matters**

In the context of Shariah Cooperative, the management shall submit the complete and accurate information to the Shariah Committee promptly and be transparent about any areas which require clarification by Shariah Committee. This is to enable them to carry out their duties effectively. The management is expected to allocate resources and sufficient labor to support Shariah governance, budget allocations, reference materials as well as research, training and development.

The management is also responsible for providing education and continuous training programs related to internal party including the Board, the Shariah Committee and staff associated with Shariah and finance matters. The aim to ensure that each Shariah governance remain alert to the society developments. In addition, management has to make sure that all the employees understand each product offered by Shariah cooperative especially at the foundation level - the basic concept of Shariah, the



similarities and differences between the Shariah and conventional cooperatives products. The management should also be responsible to ensure that operations carried out in accordance with Shariah policies and procedures. The operation should be constantly review and update it to make it more responsive to market practices and current developments.

According to No. 35.3/Per/M.KUKM/X/2007 on the soundness of Islamic financial cooperatives and No. 39/Per/M.KUKM/XII/2007 on the supervision of Islamic Financial Cooperatives, Shariah assessment is mentioned as one crucial part in assessing the soundness of cooperatives. Assessment of compliance aspects is intended to assess the extent to which Islamic principles are implemented by KJKS / UJKS cooperative in carrying out its activities as Islamic financial institutions. The Shariah board members including the number, the effectiveness of Shariah board meeting, the appointment of Shariah board members. Ahmad and Al-Aidaros (2015) have shown that most auditors agree that there is a need to enhance their knowledge and expertise in Shariah auditing in order to improve and master Shariah accounting and auditing processes.

a) **Audit and Performance Assessment**

The elements that have to be monitored from the financial statements include organizational aspects, management aspects, financial aspect, products and services,

members aspect, administrators, managers, supervisors and employees. The cooperatives should also identify the factors influencing the performance. Knowing those factors could trigger the cooperatives to boost the performance. Accordingly, Aini, Hafizah & Zuraini (2012) found that cooperatives' strategic planning and participation from their members are the identified factors that contribute to their overall success and performance.

b) **Accountability and transparency**

It is very important to develop the structure, systems and proper strategies that can allow cooperative to build their strength and bring lasting benefits to their members. With a good framework and an efficient oversight and monitoring structure can help cooperative in discharging its accountability to its members, donors and regulators. To promote transparency, cooperatives shall submit a regular report to the authorized parties consisting of: Monthly report, Quarterly Report; and Annual Report.

#### **4.0 COMPOSITION, ROLE AND PERFORMANCE FRAMEWORK FOR COOPERATIVE MANAGEMENT**

Economic prosperity should not be measured only by comparing the percentage increase from one period to another, but it should also include the human quality dimension as an integral function. The current situation offers both opportunities and challenges for Islamic co-operatives. In terms of opportunities, the stakeholders of the industry can influence policy formulation at early stages to ensure the new regulatory setting and addresses other related issues in regulating Islamic co-operatives. In this respect, the roles of professionals as transformational regulators, effective executors and implementers are undeniable. They can make use of their skills, talent and experiences to

design a dynamic management process which begins with a belief in the potential of people (Nik Mustapha, 2012).

The Quran affirms man as the best of all the creations. Allah SWT says,  
“Verily, We created man of the best stature (mould)” (Al-Tin, 95: 4).

This positive attitude towards the nature of human potential provides a strong commitment that every human potential in an organisation has to be fully explored for the benefits of all parties (Nik Mustapha, 2012). Islamic finance institutions are perceived to have higher exposure to the operational risk due to lack of proper risk systems and trained staff. In the new financial environment, there will be more reliance on risk monitoring and management. Regulatory bodies are also required to devise proper training for their staff. Regulators and supervisors should also develop a better understanding of certain practices of the financial institutions in assessing and monitoring risks (Hossein, A. et al., 2010). This statement is agreed by Nana (2010) who identified the factors that contributed to the survival of the cooperative union which the main factor is the presence of strong leadership and good management.

#### **4.1 Organisational Structure of Co-Operatives**

Co-operatives have a well-defined and long-established governance structure (Hannan, 2014), which clearly outlines their ownership and decision-making processes. Knowing the importance of co-operatives, it is significant to explore and examine how the relationships and processes within co-operative governance generate a spillover effect (whether incidentally or intentionally), which is capable of reducing poverty at the household and wider village levels (Hannan, 2014).

Although ‘governance’ is originated in a private sector, corporate governance also involves in all organised business activities including co-operatives as they are a form of a corporation. This chapter discusses the components of organisational structure of a co-operative, the role of members in general meeting, the board members, the external auditors, the advisor or patron, the internal audit committees, the role of the committee as well as the role played by the management of the co-operative.

As for the Islamic co-operative, the main governance organs which comprise the board of co-operative, the management, the shari’ah committee and the audit committee must be accountable enough on their roles and responsibilities in order to practice a good governance successfully. Good co-operative governance is built upon the relationships between the members of co-operatives, the board of members and the management (Huang C. C. et al., 2013). Furthermore, corporate governance is much more than the determination of directors’ pay and conditions and procedures for election to the board. It involves the values and expectations of the stakeholders of the business (John Donaldson, 2003).

Administration and management systems of co-operatives can be seen as a whole when we refine the roles and relationships between the components contained in the organisational structure of co-operatives. The extent to which the components may play

a role and complement each other (complement) to each other will determine the performance and effectiveness of a particular co-operative.

#### **4.1.1 Board of Co-operative**

Co-operative boards play a significant role in linking the managers' actions to the members' and customers' interests. The boards are principally responsible for monitoring the management performance, forming long-term strategic plans, evaluating proposals presented by management, and understanding financial and strategic actions undertaken by the co-operatives. A better understanding of governance and performance dynamics may aid co-operatives in creating more effective boards (Bond, 2009). The main function of the Board is to control managers, i.e. to monitor and ensure that management acts in the best interests of shareholders (Cornforth, 2004).

Board members of co-operatives are located in the second level in the organisational structure. This situation shows that the board members are elected and given a mandate by the other members at the annual general meeting to lead the co-operative. Their role is to administer and manage the co-operative as possible in order to achieve their goals. The role should be based on the direction of a predetermined mutual co-operation of members in general meeting. Policies, decisions and activities undertaken by the board should be accompanied with needs and desires of the members at a general meeting (Idris & Mohd Safaai, 2012).

In order to enhance the standard of corporate governance in Malaysia, the Committee realised that there is a need to create a new generation of board directors who are knowledgeable in their duties towards the companies' affairs (Kamini Singam, 2003). There is a need to educate the board to be more proactive in the decision making process of the company, supervising management and directors who will strive to ensure the success of their company within the purview of legal frameworks (Anil Joshi, 2000).

*Subsequently, in 1998 – 1999, there was an introduction and implementation of the Code on Corporate Governance and Code of Best Practice, which focuses on educating directors as to their roles and responsibilities, monitoring management via the usage of various committees in particular the 'audit committee', extending the role of independent directors and auditors, reinforcing and extending the rights of members to correct and prevent a wrong or an abuse of power by the board of directors (Anil Joshi, 2000).*

The role of the board has changed from management support to organisational leadership and this represents a paradigm shift in management thinking (Pound, 1995). This statement is further supported by Kiel et al. (2005) that the boards are increasingly held accountable for corporate performance where they become more proactive in the leadership of the companies they govern. Effective leadership is seen critical to establishing the tone of a corporation (i.e. its culture and values), developing a strategic direction, guiding change and formulating corporate objectives, and ensuring effective implementation.

In the Report on Corporate Governance produced by the Finance Committee in February 1999, it was clearly spelt out that “good corporate governance rests firmly with the Board of Directors (of public listed companies) and that shareholders and auditors necessarily only play secondary roles. The finance committee reported that every public listed corporation, it should be headed by an effective board to lead and control the company. There should be a balance between the executive and non-executive directors to ensure that there is no individual who can exert control during decision making (Raja Dato’ Arshad, 2000).

The board need to administer and manage the co-operative in accordance with the limits and jurisdiction of which have been determined in co-operative laws, directives and circulars issued by the registrar of co-operatives from time to time. They have to assume accountability over all decisions and actions that affecting business and co-operatives. As in any case where they apparently have failed to administer and manage the co-operative well, then the appropriate member has the right and the power to take action, even up to the level to drop or change them with others in the next general meeting. Lang (2000) reports that co-operative leaders believe smaller boards may make it possible for members to be more selective in voting for directors and lead to greater accountability, less anonymity, and more efficient meetings. The structure or composition of the board has an influence on the effectiveness of the board (Huang C. C. et al, 2013).

According to a study by Kiel et al., (2005), governance failures can cause a significant reduction in shareholders’ wealth. It may also cause a wider impact on the economic and social due to the closure of businesses and loss of jobs in the community. Given the major implications of corporate failure, it is important to understand how the board contributed to this failure. Kiel et al., (2005) classified into four categories of failure: strategic, control, ethics and interpersonal relations and all were found to be closely related to each other. Institutional investors perceive that the board can directly enhance shareholder value by intervening in the case of corporate crises, providing strategic guidance and selecting and monitoring the CEO (Conger et al.1998). Thus, all these aspects must be concerned in setting up a good governance.

In Islamic co-operative, the board has the authority and ultimate responsibility for the overall governance and compliance with shari’ah among co-operatives which includes:

- i. establish appropriate mechanism to implement responsibility; and
- ii. perform shari’ah governance visit and ensure that it meets the capacity, size, nature of co-operative business.

The board shall ensure that the shari’ah committee (SC) understands their fiduciary duties in performing their roles and responsibilities. For further monitoring, the SC must prepare a periodic reports on the meetings held. It is also a duty of the board to set up an effective communication policy to facilitate discussion related to shari’ah matters as well as to ensure the staffs understand the needs of the co-operatives to comply with the shari’ah requirements at all times. Furthermore, the board shall provide appropriate

adjustment to the SC. Forms of remuneration shall be commensurate with the accountability, tasks and SC responsibilities.

From the activities of the board, Hillman and Daziel (2003) conclude that, there are two types of board related capital that is board capital consists of human capital (experience, expertise, reputation) and relational capital (networking to other firms, and external contingencies).

#### **4.1.2 Shari'ah Committee (Shari'ah Advisor)**

Islamic financial institution (IFI) must adhere to the best practices of corporate governance. However, there is an extra layer of supervision that require investigation that is shari'ah governance which is under supervision of SC. They have to ensure the shari'ah compliance of the overall operations of the IFI without any contrary activities to shari'ah principles (Rusni Hassan et al., 2013).

In Malaysia, SC is responsible to review the shari'ah compatibility and compliance of any financial transaction in the Islamic banking and insurance (Ishak, 1997). Rodney Wilson (2009) also has emphasised the role of SC in assisting the regulations implementation and the process of shari'ah compliance. In addition, Sudin Haron (1997) discovers that the duties and responsibilities of shari'ah boards (SB) is not standardized among the IFI. However, their general functions are providing guidelines and offering advice to banks, conducting shari'ah audits and making decisions on matters which have religious repercussions.

According to GP 28, the SC of cooperatives should be aware of and responsible for all decisions, insights and opinions in relation to the affairs of the shari'ah. Although the board has responsibility and accountability for the overall governance of the cooperative, the board shall depend on the SC consideration and decisions on matters relating to the co-operative affairs.

Among the responsibilities of the shari'ah committee are:

- i. To identify issues that require attention and propose preventive and corrective measures, if necessary.
- ii. To report directly to the board on matters pertaining to shari'ah matters. This reflects the status of the SC as an independent body in the co-operative.
- iii. To disclose sufficient information in the annual report of financial co-operatives regarding the shari'ah compliance activities.

#### **4.1.3 Co-operative Management**

In an organisation, the management team holds a big role and responsibility in running their operation successfully. This require effective management to determine the co-operative direction and lead the organisation to achieve its missions and visions. By using appropriate types of controls, an effective Management Control System (MCS) can direct the manager behavior towards co-operative goal which in turn can increase co-operative

performance. Issue on top management influences on MCS is of a current interest as the theoretical insights and empirical findings on this is still lack (Sheaffer & Dossi, 2014).

The final component that complements the structure of co-operative organizations is the management, which is no less important role in determining the success of a co-operative. The workforce management is appointed by the board to manage the daily operations of the co-operative. A co-operative management should have the necessary skills and qualifications for the implementation of policies, decisions and actions that have been determined by the board from time to time.

The management shall immediately submit the complete and accurate information to the SC and be transparent about any areas that require clarification by SC, to enable them to carry out their duties in effective manner. The management to allocate resources and adequate manpower to support shari'ah governance, budget allocations, reference materials as well as training, research and development. The management is responsible for providing education and continuous training programs to relevant internal parties including the board, the SC and staffs, associated with shari'ah and finance matters. It aims to ensure that each shari'ah governance functions in the co-operatives remain alert to the development or adjustment of shari'ah affairs.

All employees are expected to understand every Islamic products offered by co-operatives especially on the basic concepts of shari'ah and the similarities and differences compared to the product and conventional concept. Policies and procedures should be able to explain the shari'ah law related to the governance process from the beginning until the end. The management should also be responsible for ensuring that operations are conducted in accordance with policies and procedures.

A strong co-operation between the board and the management team is required to ensure the success of the co-operative. The manager are motivated to behave towards a firm which in turn can improve the performance of co-operatives when they are clear about their role and the board's expectations.

#### **4.1.4 Internal Audit Committee (IAC)**

To ensure the effective administration and management of the co-operative, the internal control system should be established. One way is through the role played by the IAC to examine the accounting records and other records relating to the co-operative transaction. IAC should ensure that the administration and management of the co-operative in accordance with its goals, co-operative law and decisions made at the general meeting. IAC shall submit and present the audit report to the board, general meetings and CCM.

The role played by IAC important to ensure internal control co-operative running well from time to time. With this, any shortcomings and problems arising in the administration and management will be detected early by the IAC before it becomes severe and uncontrollable. Therefore, any report to the board and the annual general meeting of the IAC will be noted accordingly and follow-up actions should be undertaken immediately by the parties concerned (Idris & Mohd Safaai, 2012).

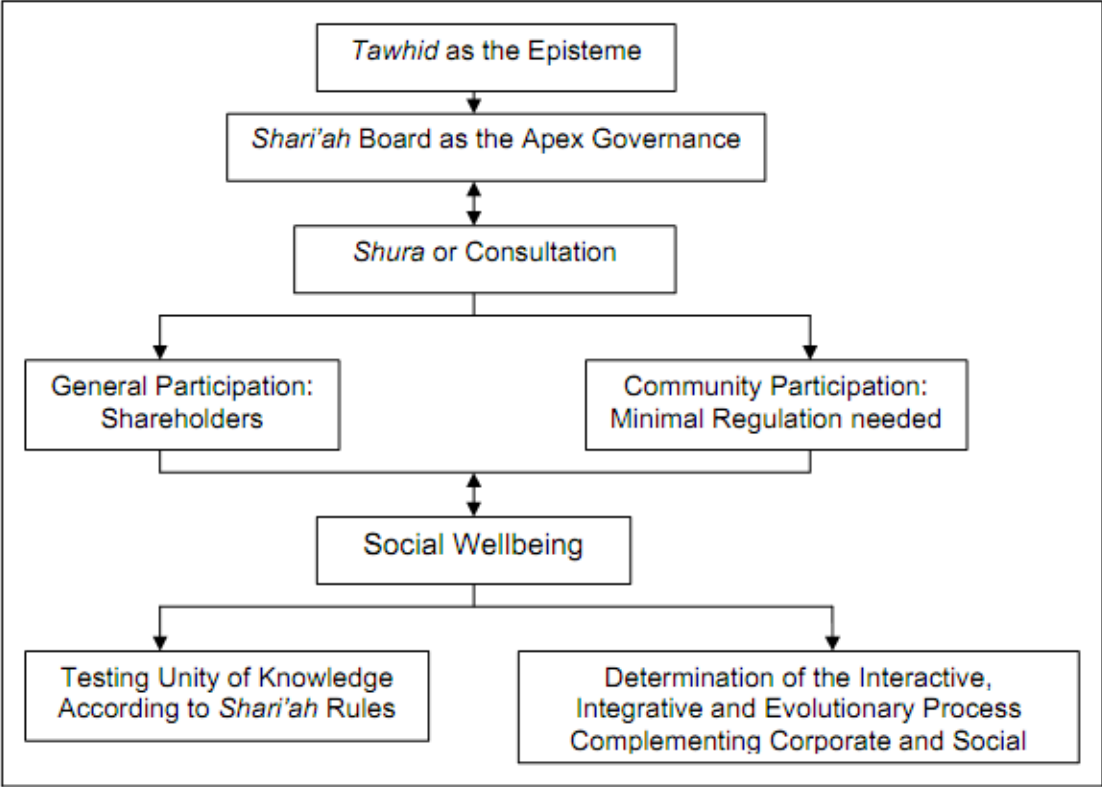
According to GP28, IAC should play an important role to ensure an efficient of internal control system and sound risk management. It should able to provide independent valuations and could be a benchmark for shari’ah compliance. As stated in GP28, IAC responsibility shall include the following:

- i. to ensure that management has complied with the policies and procedures with respect to the shari’ah affairs as determined by SC;
- ii. to monitor the implementation of recommendations issued by SC on administrative and financial management.
- iii. to investigate the matter as directed by SC;
- iv. to report to SC and the board with respect to any inconsistencies that occur in administration and financial management.
- v. to review the adequacy of the shari’ah governance process; and
- vi. to review and advise the SC on any suspicious transactions.

According to the audit practices and reports, IAC can be given an adequate allowance. However, this payment is subject to the approval of members at the general meeting of the co-operative.

**4.2 Theoretical Framework on Governance Model**

Choudhury and Hoque, (2004) discuss the fundamental Islamic epistemology of *Tawhid* on their corporate governance model.



**Figure 6:** *Tawhid* and *Shura* Based Approach  
 Source: Choudhury & Hoque (2004)

*Tawhid* is the foundation of the Islamic faith. Therefore, the framework of corporate governance should also be based on this concept. Allah SWT says in Al-Quran;

*“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.” (Surah Ali Imran 3: 191).*

This paragraph describes the basic principles of governance in which all are created by Allah on this earth has a purpose. In fact, man was created to be the *khalifah* and Allah has placed in trust for mankind as a vicegerent to play an active role to monitor and engage in the human affairs. As Allah knows everything and everyone is responsible to Him, *Tawhid* principle should be the basis of the model of corporate governance in Islam as the parties involved in the corporation accountable to Allah (Chapra, 1992).

Malaysia’s legal and regulatory framework for Islamic banking and finance (IBF) has always been referred to as the most comprehensive in the world. Referring to the objectives of this study, which is to explore and examine on the shari’ah governance and its compliance in the co-operatives, a SGF for IFI is found suitable to support this study.

SGF is an organisational arrangements for IFIs to ensure effective supervision, responsibility and accountability of the BODs, management and SC to lead the business operating environment always adhere to the principles of shari’ah. The SGF mentions the accountability and responsibility of the main organs as they are the backbone of each institution. These guidelines are applicable to all the IFIs under the supervision of BNM. This includes all Islamic banks operating pursuant to the Islamic Banking Act (IBA), all financial institutions participating under the Islamic Banking Scheme under BAFIA, all development financial institutions which carry out the Islamic Banking Scheme, and all the takaful operators operating under the Takaful Act.

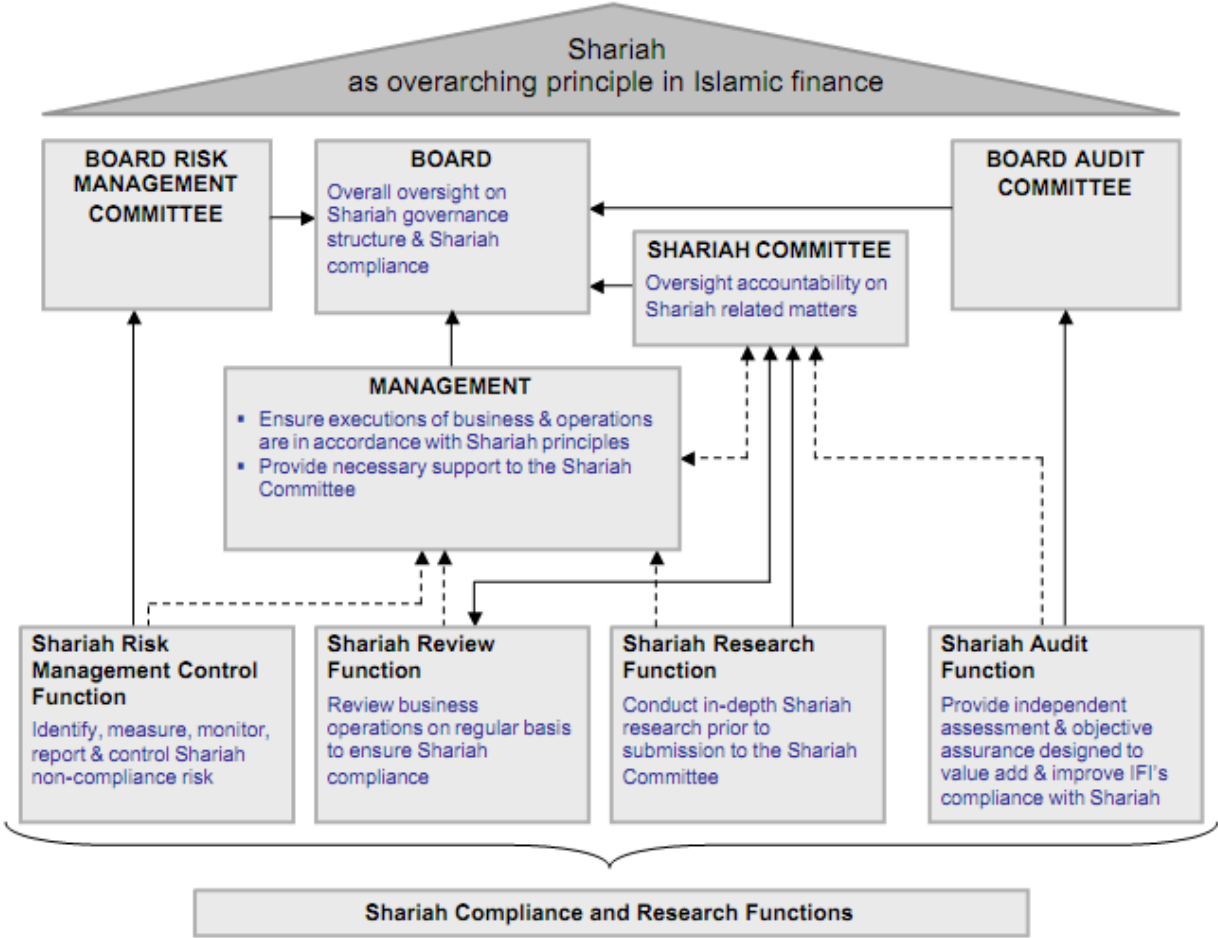
The framework came into effect in January 2011 to provide a comprehensive SGF for IFIs regulated and supervised by BNM. The framework is issued pursuant to Section 59 of the CBMA 2009, Section 53A of the IBA 1983, Section 69 of the TA 1984, Section 126 of the BAFIA and Section 126 of the DAFIA (SGF, 2010).

From the diagram below, it presents the five important organs in the Islamic financial intermediaries, how they function and integrate with each other. This study intends to explore the role of the main organs of the administration and management of co-operatives that is a member of the BODs, the management team, the SC and the IAC. This study would like to examine the extent to which these co-operative organs understand and perform their duties accordingly to comply with GP28.

In the Financial Stability Report (2010), Tan Sri Dr. Zeti Akhtar Aziz, Bank Negara Governor highlighted that the SGF aims to serve as a comprehensive guidance on the roles and



responsibilities of the SC, the BOD and management in order to ensure the operations of IFI is compliance to shari’ah principles. In measuring the IFIs compliance to the Shariah, SGF requires regular internal Shari’ah reviews and Shari’ah audit (Zurina et al., 2013). A history has shown that improvement in the aspect of Shari’ah governance can assist the speedy and better growth of the Islamic finance industry (Abdussalam Ismail & Abdussalam Mikail, 2013). The same perception is reserved to the other Islamic social finance industry especially the co-operative sector.



**Figure 7:** Shariah Governance Framework Model for Islamic Financial Institutions  
 Source: Shariah Governance Framework for Islamic Financial Institution (BNM), 2010

The IFSB-10 has defined the Shari’ah Governance System as a set of institutional and organisational arrangements through which a IFI ensures that there is effective independent oversight of shari’ah compliance over the issuance of relevant shari’ah pronouncements, dissemination of information and an internal shari’ah compliance review. The AAOIFI has decided that the Supervisory Board should go beyond the role of shari’ah advice and approve the structure of IFI activities. In this regard, it is believed that shari’ah experts and the Shari’ah Supervisory Board have more important role to play. They must engage in a process of internal and external governance shari’ah, which include structuring, assist in drafting, reviewing and approving documentation for

shari'ah compliance transactions. This is to ensure adequate compliance and increase certainty, consistency and transparency in the enforcement of such transactions.

Furthermore, the Supervisory Shari'ah Boards should continue to oversee the implementation and operation of related products to ensure that they comply with all the terms of the principles shari'ah. However, the effectiveness of the internal audit significantly depending on the quality, training and experience of its staff. The aim is to appoint staffs with appropriate accounting and shari'ah background, personal qualities and potential. Further improvement should be taken to provide the necessary experience, training and ongoing professional to develop the human capital (Zurina et al., 2013).

The comprehensive arrangements of SGF which cover all aspects of IFIs operations are considered solid. Every principles applicable is spelled out clearly to reflect the intergrity of the IFIs in the long-run. On this basis, the SGF is found relevant and suitable to be a benchmark in an Islamic co-operative setting.

## **5.0 PERFORMANCE MEASUREMENT FRAMEWORK IN SHARIAH-BASED COOPERATIVES AS A MEASURE OF CONFLICT OF INTEREST DETERRENCE: BMTS AS A CASE STUDY**

Baitul Maal wat Tamwil (BMT) is a Micro Finance Institutions (MFIs), which operates based on the principles of Shari'ah. BMT has two main functions. Bait al Maal is defined as a financial institution that manages funds activities for social purposes and the source of the funds obtained from zakat, infaq, sadaqah and waqf or other lawful sources. Bait at Tamwil is an institution conducting business and investments in improving for commercial purposes.

BMT basically must perform well in both financial and non-financial (social) purposes. The organizations should be able to find proxies to measure both financial and non-financial performances. Some past studies uses the efficiency proxy to measure the financial and operational performance. BMT should determine the inputs and outputs of the BMT operation. The other aspect could be the implementation of good governance in BMT. The performance measurements for Islamic cooperatives and BMT should be different from the any profit sector because the dual roles of BMT.

This sub-section discusses the three sub performance measurements that should be evaluated in BMT and Shariah cooperatives, including financial performance, social performance and governance.

### **5.1 Financial Performance**

According to the definition and nature of BMT, it is clearly highlighted that BMT is a combination of profit oriented and non-profit organization. It is a making profit organization and social institution at the same time. In any organization, three key characteristics frequently play a dominant role in organizational performance namely organization's resource-acquisition ability, the attainability of the organization's goals, and organizational efficiency (Mensah et. al, 2008). The organizations should be able to find proxies to measure efficiency. Some researchers try to measure from good

governance perspectives (Dewi et al). Atan et al (2013) proposed performance efficiency ratio and operating efficiency ratio to measure the performance. Even though those ratios explore the institution efficiency; they argued that those two ratios are the suitable indicators to measure the consistency of the institution.

In terms of financial performance, the general measurements are financial and operational indicators. Financial performance relates more on the financial soundness of the Islamic cooperatives / BMTs and the organizations' ability to generate profits from the operations. Operational performance describes the efficiency of the BMTs. It relates to how the BMTs manage the expenses and expenditures to generate maximum profits. BMT business sector is mostly like banking operation. BMT can refer to Islamic banks in assessing the financial performance.

Banking industry usually adopts CAMELS to evaluate the performance and soundness of the bank. CAMELS has been widely used as an effective indicator in banking activities (Beseiso, 2014; Dang, 2011). CAMELS stands for capital adequacy, asset quality, management efficiency, earnings, liquidity position and sensitivity to the market (Beseiso, 2014; Dincer, Gencer, Orhan & Sahinbas, 2011).

Capital adequacy ratio shows the capital expected to meet the liabilities and banking risks. Asset quality depicts the level of risk in the assets. The poor asset quality could be the main cause of bank failures. Management quality shows the capability of the directors and management ensures the efficient operations, sound financial condition, and the compliance to certain regulations. Management quality also describes the ability of the management to manage the efficient business activities, dealing with income and expenses (Lahrech et al, 2014; A. Rashid & Jabeen, 2016). The following table displays the ratios of CAMELS mostly used in the banking industry.

**Table 7:** CAMELS Framework

Category	Ratio	Calculation
Capital Adequacy	Capital Adequacy ratio	Total capital (Tier 1 and Tier 2)/ Risk-weighted assets
Assets Quality	Non-performing loans ratio	Non-performing Loans / Gross Loans
Management Quality	Cost efficiency ratio	Total cost/total income
Earnings	<ul style="list-style-type: none"> <li>• ROA</li> <li>• ROE</li> </ul>	<ul style="list-style-type: none"> <li>• Net profit / Total assets</li> <li>• Net profit / total equity</li> </ul>
Liquidity	<ul style="list-style-type: none"> <li>• Loan to deposits ratio</li> <li>• Current assets ratio</li> </ul>	<ul style="list-style-type: none"> <li>• Loans/Deposits</li> <li>• Liquid assets / Total assets</li> </ul>
Sensitivity to Risks	Asset risk ratio	Total assets/ Assets Sector

Source: Dincer et al, 2011; Lahrech et al, 2014)

## **5.2 Governance Structure**

In terms of governance, the thing that distinguishes cooperative management with general management is the elements of cooperative management consisting of annual general meeting, trustees and supervisors. The tasks can be described as follows: Annual general meeting establishes the budget base, issue public policy, appoint/dismiss trustees / administrators and supervisors. Cooperative trustees / administrators / management are in charge of cooperatives business and the supervisors have task to oversee the performance of trustees. For a big cooperative with many business units, it is possible to appoint a manager and employees to run its business. Manager or employees are not the members of cooperative (and should indeed be taken from outside the cooperative) so that the supervision will be easier. They work as assigned by the trustees, then they are also responsible to the trustees. For Islamic cooperatives, they must have Shariah committee or Shariah Advisory Board in the body of cooperative. They must ensure that the process, products and people fulfil Shariah requirements. However, in practice, those Shariah members focus more on the products, they just want to ensure if the products are in line with Shariah or not.

In the context of cooperative organization, governance is very crucial due to its purpose of upholding the integrity of an organization in fulfilling the purpose for which it was established. Therefore “cooperative governance” can preserve the cooperative identity. The cooperative in Indonesia is considered as one of the largest domestic society organizations as well as social enterprises with great potential in rural development and employment creation. However, the quality improvement is not as significant as its development. It requires a strong commitment and good governance to build a cooperative being able to survive. Indonesian act Shariah cooperatives highlights the issues of Management function Supervisory function Shariah Assessment Audit and Performance Assessment, Accountability and transparency to ensure the soundness of the cooperatives.

Malaysia also has the increasing number of cooperatives indicating that people are more confident with cooperatives. Therefore, governance must be in place to ensure a good conduct is practicing in the organization for its sustainability. The clear roles of board management, the establishment of Shariah Committee and other aspects will enhance the credibility and soundness of cooperatives. The Board have to confirm that the Shariah Committee understands their fiduciary responsibility in carrying out its duties. The Board also Shariah Committee shall monitor performance through periodic reports.

## **5.3 Governance in BMT / Islamic cooperatives in Indonesia**

The ministry of cooperatives and SMEs issues acts No. 35.3/Per/M.KUKM/X/2007 on the soundness of Islamic financial cooperatives and No. 39/Per/M.KUKM/XII/2007 on the supervision of Islamic Financial Cooperatives. According to the practices in the abovementioned institutions, governance practices in cooperative sector have not clearly established. However, according to the act stipulated by the ministry of cooperatives and SMEs, the initiatives for cooperative governance can be highlighted. There are at least five functions and assessments as follows:

**a) Management function**

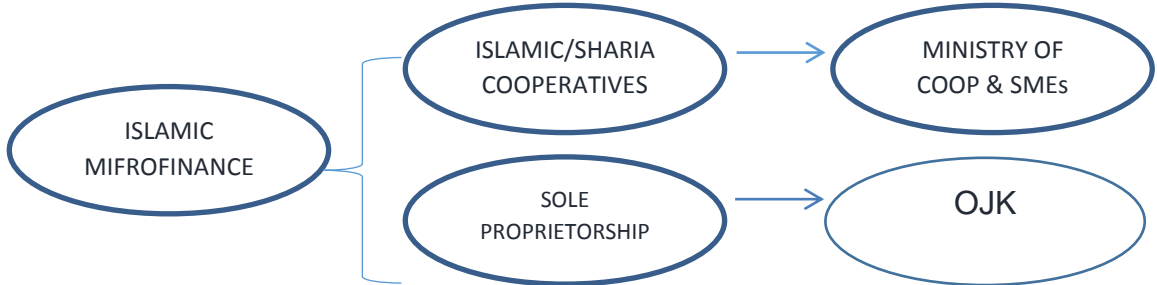
Koperasi Jasa Keuangan Syariah (KJKS) / Unit Jasa Keuangan Syariah (UJKS) cooperatives should assess management aspects which cover general management itself, institutional matters, capital and equity management, assets management and liquidity management to ensure the soundness of the organization. The KJKS/UJKS cooperatives should ensure that the level of soundness would not decrease due to the violations of the internal and external policies and UJKS managers have not been given full authority to manage the business.

**b) Supervisory function**

Supervision is an activity of coaching, monitoring, inspecting, and assessing cooperative’s soundness to ensure that by Islamic cooperative are run based on Shariah principles and maintain the trust of stakeholders. The cooperatives should has Internal Control System as a policy and procedure which is run by the supervisor, the board and management of KJKS and UJKS cooperative to provide reasonable assurance of the reliability of financial statement, and also the compliance with laws and regulations in supporting the effectiveness and efficiency of operations.

Supervisory function should control and ensure that KJKS and UJKS cooperative carrying out the activities in accordance with applicable laws and regulations. It should be able to improve the image and credibility of KJKS and UJKS as financial institutions being able to manage funds from members, prospective members, other cooperatives and or its members based on the cooperative principles.

Discussion on the general supervision of Islamic cooperatives in Indonesia, the cooperatives and the Islamic Financial Cooperative (Koperasi Jasa Keuangan Syariah - KJKS) will not be supervised under the Financial Services Authority (Otoritas Jasa Keuangan - OJK). These two types of cooperatives will be supervised by the Ministry of Cooperatives and Small and Medium Enterprises. There are two overarching regulation of microfinance institutions namely the Cooperative Act No. 17 of 2012 and Act No. 01 Year 2013 on Micro Finance Institutions. The existence of the two regulations is interrelated. Based on the two regulations above, the legal entity of micro finance can be in two forms, either cooperatives or sole proprietorship. If the legal status is a cooperative, so it will be supervised by the Ministry of Cooperatives and Small and Medium Enterprises. If a legal entity is a sole proprietorship, it will be supervised by the Financial Service Authority.



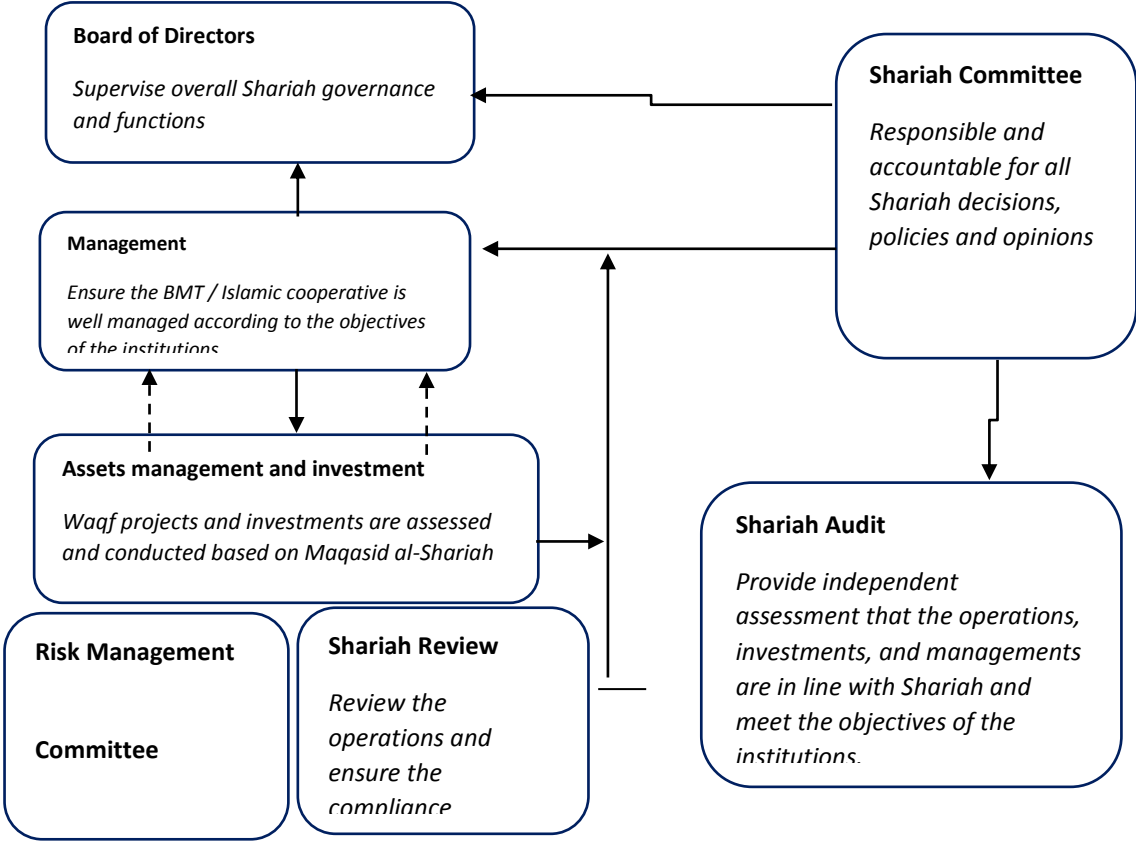
**Figure 8:** The governance structure of Shariah-based Cooperatives in Indonesia

**c) Shariah Assessment**

Assessment of compliance aspects is intended to assess the extent to which Islamic principles are implemented by KJKS / UJKS cooperative in carrying out its activities as Islamic financial institutions. The Shariah board members including the number, the effectiveness of Shariah board meeting, the appointment of Shariah board members. Ahmad and Al-Aidaros (2015) have shown that most auditors agree that there is a need to enhance their knowledge and expertise in Shariah auditing in order to improve and master Shariah accounting and auditing processes.

**d) Audit and Performance Assessment**

The elements that have to be monitored from the financial statements include organizational aspects, management aspects, financial aspect, products and services, members aspect, administrators, managers, supervisors and employees. The cooperatives should also identify the factors influencing the performance. Knowing those factors could trigger the cooperatives to boost the performance. Accordingly, Aini, Hafizah & Zuraini (2012) found that cooperatives’ strategic planning and participation from their members are the identified factors that contribute to their overall success and performance.



**Figure 9:** The proposed framework of Shariah governance for BMT/Shariah Cooperatives institutions

#### e) **Accountability and transparency**

It is very important to develop the structure, systems and proper strategies that can allow cooperative to build their strength and bring lasting benefits to their members. With a good framework and an efficient oversight and monitoring structure can help cooperative in discharging its accountability to its members, donors and regulators. To promote transparency, cooperatives shall submit a regular report to the authorized parties consisting of: Monthly report, Quarterly Report; and Annual Report.

As for BMTs / Islamic cooperatives, Shariah is the basis of business practices and Islamic finance where adherence to Islamic beliefs, principles and conditions specified in Shariah is the main objective. Both Malaysian and Indonesian government also supports the development of Shariah cooperatives. It is shown in the guidelines issued under section 86B Cooperative Societies Act 1993 (the Act) in Malaysia to regulate cooperatives doing business or compliant activity including compliance with the requirements of Shariah and Cooperative Shariah governance. In Indonesia, the government issue acts No. 35.3/Per/M.KUKM/X/2007 on the soundness of Islamic financial cooperatives and No. 39/Per/M.KUKM/XII/2007 on the supervision of Islamic Financial Cooperatives. Governance of Shariah-based cooperatives is useful for regulators in both countries to promote growth of cooperatives as clear governance structures are vital to ensure integrity and accountability of cooperative management. At the end, cooperative governance will also enhance the trust of the society to involve more in cooperative sectors.

#### **5.4 Social Performance**

In assessing social performance, BMT and Shariah cooperatives may adopt the accountability assessment standards as proposed in Table 8 below. The standards are required to promote public trust in such organizations. The standards are expected to enhance transparent practices. The framework covers the following assessments:

**Table 8:** Proposed Accountability Standards

<b>Dimension</b>	<b>Measurement</b>
Governance	<ol style="list-style-type: none"><li>1. The existence of a governing board with at least five members</li><li>2. A number of mutawalli</li><li>3. Independent board (not more than 10% compensated persons)</li><li>4. A minimum of three board meetings per year</li></ol>
Effectiveness	<ol style="list-style-type: none"><li>5. A board policy of assessing, no less than every two years, the organization's performance and effectiveness and of determining future actions required to achieve its mission</li><li>6. A written report that outlines the results of the aforementioned performance and effectiveness assessment and recommendations for future actions.</li></ol>
Finance	<ol style="list-style-type: none"><li>7. Spend at least 65% of its total expenses on program activities.</li></ol>

	<ol style="list-style-type: none"> <li>8. Spend no more than 35% of related contributions on fund raising.</li> <li>9. Avoid accumulating funds that could be used for current program activities.</li> <li>10. Make available to all, on request, complete annual financial statements</li> <li>11. Include in the financial statements a breakdown of expenses</li> <li>12. Have a board-approved annual budget for its current fiscal year</li> <li>13. Accurately report the charity's expenses</li> </ol>
Fund Raising	<ol style="list-style-type: none"> <li>14. Have informational materials</li> <li>15. Include on any charity websites that request contributions</li> <li>16. Address privacy concerns of donors by providing in written appeals, at least annually, a means (e.g., such as a check off box) and providing a clear, prominent and easily accessible privacy policy on any of its websites</li> <li>17. Respond promptly to and act on complaints</li> <li>18. Clearly disclose how the charity benefits from the sale of products or services</li> </ol>

Mostly, Islamic cooperatives and BMTs implement PSAK 101 as the accounting standard for Islamic financial institutions. BMT is unique because it is a cooperative providing Islamic financial products. According to the two BMT case studies, it was agreed that accounting standard will make it easier to evaluate the performance. According to the interview results, it can be summarized in the following word cloud (interview result is analysed using Nvivo 11 pro).



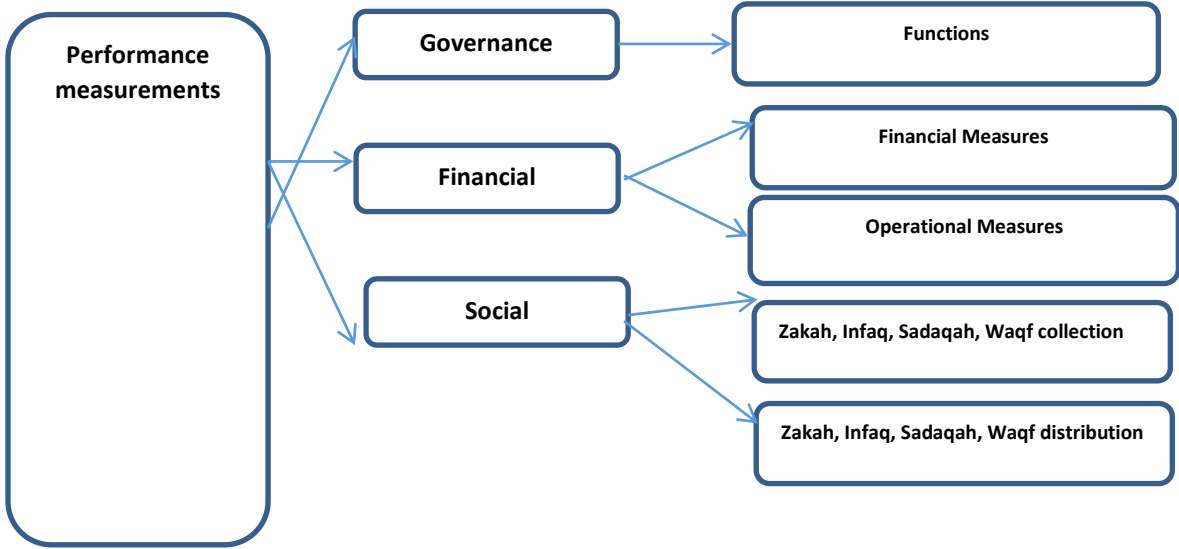
**Figure 10:** Word Cloud of BMT performance measurement



Based on the interview with the accounting regulator in Indonesia that enforces PSAK, there are a number of themes appeared. Those themes are financial performance, organizational performance, non-financial performance, accounting performance based on PSAK, efficiency, low cost financing, society, and income. These themes can be categorized into two namely financial performance (accounting performance based on PSAK, efficiency, low cost financing, income) and non-financial performance (organizational performance, society). Both financial and non-financial measurements will be beneficial for the organizations. For financial performance, it can be easily measured using the total income. Furthermore, it can be measured through the conformance with PSAK Shariah (Shariah Financial Accounting Standard). Other than that, the organization will have the targeted amount income. It can also be measured by the efficiency of the organization in managing its assets. In terms of non-financial measurement, for example the structure and capability of the organization will also boost the financial performance. For non-financial measurement, the role of the organization towards society welfare and good governance could be the indicators. BMTs should be able to manage and distribute the benefits generated from Islamic social funds such as zakah, infaq, sadaqah and waqf.

Accountability is important to ensure the discharging of the trustworthiness of the management. Accountability of any organizations can be observed more easily through the reporting and disclosure practices. The existence of accountability framework will assess how the institution perform and be accountable as an agent to manage the third party funds or other social funds. The accountability framework will promote transparency, uniformity and consistency of reporting.

Besides making profit, BMTs have social role to manage social funds including zakah, infaq, sadaqah, and waqf. This social performance can be measured using the ability of BMTs to manage and distribute the benefits of social funds. Therefore, BMTs or Islamic cooperatives should be evaluated using a more comprehensive performance measurement framework as follows:



**Figure 11:** The proposed framework of Islamic cooperatives / BMT Performance Measurements

**6.o SHARIAH ASSURANCE MODEL IN SHARIAH-BASED COOPERATIVE**

In addition to the performance measurement framework that reports the accountability for financial and non-financial performance of cooperatives to serve as measures to mitigate the issue of conflict of interest between BOD, manager and cooperative members, Shariah assurance aspect has to also be taken into account. Compliance with Shariah will be better achieved by having a proper Shariah assurance process. Shariah Assurance model development proposed need to be leveraged against the guidelines issued by the regulators in the Islamic finance industry (Islamic banking, takaful and Islamic capital market).

The Shariah assurance model for Shariah-based cooperatives is benchmarked based on the Shariah Governance Framework issued by the Bank Negara Malaysia (BNM, 2011), Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services (IFSB, 2009) and related guidelines by cooperative regulator, namely Suruhanjaya Koperasi Malaysia. During the benchmarking process, comparative analysis and identification of various unresolved issues and identified limitations will be addressed. Apart from this, the conceptual model integrates the concept recommended in the three line of defense model as promoted by the Institute of Internal Auditors (IIA, 2013), to ensure strict Shariah compliant of Shariah-based cooperatives business activities.

Shariah compliance monitoring requires a proper framework to ensure all transactions, practices and activities in Shariah-based cooperatives are in compliance with the Shariah while meeting its organisational objectives. The conceptual framework for the Shariah compliance assurance will explore the adoption of the three line of defence model as guidance for the effective risk management and control as issued by The Institute of Internal Auditors in 2013. This is in line with the governance definition which is a set of system to monitor and control the activities of an organisation. The justification for each level of the line of assurance process is as follows:

**i) First line of assurance (adopted and adapted from the first line of defense)**

This is self-assurance to be conducted mainly by the line managers who ‘own’ their respective processes in Shariah-based cooperatives and risk management functions to help them to identify, measure, monitor, control and report all pertinent factors to ensure Shariah compliant. Their activities are monitored and supervised by the top management. The concept is consistent with the teaching of Islam for one to always to be aware of what they do because all their actions will be queried by Allah in the Day of Judgment (Imam Al-Ghazali, 2008).

**ii) Second line of assurance (adopted and adapted from the second line of defense)**

This is a second level assurance to be conducted by the Shariah specialist group. The Shariah specialist group is the backbone for the Shariah Supervisory Committee which oversight the Shariah function. The concept of secondary assurance is based on the teaching of Islam that we need to help each other in conducting good deed and not in evil as narrated in Surah Al Ma'idah verse 2 (Imam Al-Ghazali, 2008). Osman and Shafii (2016) highlights that the Shariah specialist group is not only an assurance provider on its own line of assurance but also serve as link between the first and second line of assurance and the Shariah Supervisory Committee.

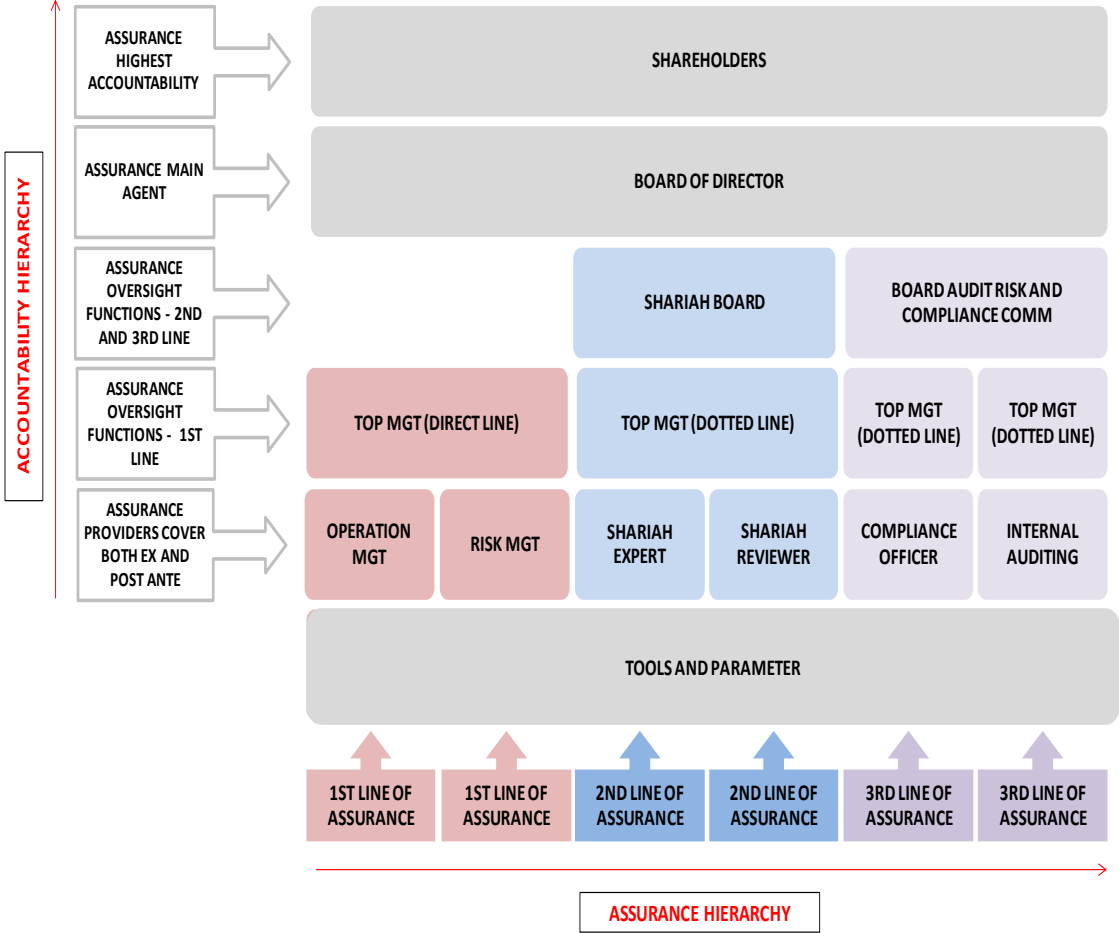
**iii) Third line of assurance (adopted and adapted from the third line of defense)**

This is an independent assurance within the Shariah-based cooperatives conducted by the Shariah compliance officer and internal audit functions. Their activities are to be monitored and supervised by the Board Audit, Risk & Compliance Committee. The concept of the third line of assurance is based on the teaching of Islam on enjoining good and forbidding evil. Allah SWT the Exalted has said in Al-Quran; Surah Al Imran verse 104, “Let there arise out of you a band of people inviting to all that is good, enjoining what is right, and forbidding what is wrong: They are the ones to attain felicity (Imam Abdullah Al-Hadad, 1998). This third line of assurance is consistent with the Hisbah practices in the past (Bhatti, M & Bhatti, I., 2010).

The Shariah assurance model for Shariah-based cooperatives is adopted from the work of Osman and Shafii (2016) on Shariah assurance model for Islamic fund management industry. Figure 1 is the proposed conceptual model for Shariah assurance. The model illustrates both the accountability hierarchy and assurance hierarchy. In term of accountability, the model proposes three levels of accountability hierarchy. The accountability hierarchy suggests the parties that should be responsible at each level for the assurance process for the assurance function to be effective. The hierarchy consists of assurance providers, assurance oversight function, assurance main agent and

assurance highest accountability.

**SHARIAH COMPLIANCE ASSURANCE HIERARCHY CONCEPTUAL MODEL**



**Figure 12: Shariah Assurance Model**  
 Source: Osman and Shafii (2016)

The parties which the responsibilities at each level are identified based on the lines of defence model commonly adopted as a risk management technique in Islamic financial institutions. Board of Directors, in order to perform its oversight role to ensure Shariah compliance, is getting the advice from Shariah Committee that provides Shariah deliberations that will be taken up by the management of the Shariah-based cooperatives. Top management members, as the parties that monitor the operations at the functional level provide the assurance at the fundamental level that the operations are performed according to Shariah. The Shariah assurance providers consist of series of functions in the hierarchy that forms the ultimate independent Shariah assurance, i.e. the Shariah audit function. The hierarchy builds up from the business unit, risk management, Shariah experts, Shariah reviewers, compliance officers and finally the internal auditors.

Shariah assurance hierarchy is expressed in the x-axis of the Model in Figure 1. It constitutes three levels of assurance; First Line Assurance, Second Line Assurance and

Third Line Assurance. First Line assurance consists of Operation Management or Business Unit and Risk Management function as they are the parties that carry out the Shariah compliant mandates within the organisation. The second line of assurance is provided by the Shariah experts in the Shariah department and the Shariah review team members. Being the second line of assurance parties, Shariah experts and Shariah reviewers pick up the Shariah non-compliance events during day to day business activities and scheduled reviews that are planned throughout the year. The third level of assurance is provided by the compliance officers and internal auditors who report their findings to an independent committee that is Board Audit Risk and Compliance Committee.

## **7.0 CONCLUSION**

A financial co-operative as a mutuality-based financial institution occupies a central position in the economy in promoting thrift, providing credit and other financial services to its members. Governance continues to be a major challenge facing such member-based entities. Lack of sound governance may manifest in many ways, including lack of a participation culture in decision-making. A dominance by a few high-networth members in the decision-making process may involve serious conflict of interest and nepotism. Board members may continue to exercise operational control even after professional managers have been appointed.

Due to the infancy of Shariah-based cooperative industry that needs for proper governance measures, this paper discuss corporate governance in Shariah-based cooperatives in an attempt to propose a model for resolving stakeholders' conflicts of interest. Section 1 introduces the issues of governance in cooperative movement and the emergence of Shariah-based cooperatives. Section 2 provides a background to the issue of governance in Shariah-based cooperatives. It reviews the state of operation and growth of Shariah-based cooperatives in Malaysia, Indonesia and Thailand that hosts significant numbers of Shariah-based cooperatives. Next, the study compares laws, supervision and oversight of Shariah-based cooperatives in these countries to identify respective cooperative governance measures that includes measures to deter conflict of interest in cooperative governance. The study goes on to discuss the composition, role and performance framework for cooperative management to build the case for the need of clear roles of governance organs in Shariah-based cooperatives. Section 5 discusses the existing practice of performance as well as proposals for performance management framework suitable to be adopted in Shariah-based cooperatives. This is to elucidate the role of performance management framework that provides measures that provides checks and balances to keep conflict of interest at bay. Finally, the paper discusses Shariah assurance framework adoptable in Shariah-based cooperatives, a vital function to ensure Shariah compliance of the institution.

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