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A Comparative Analysis of Corporate Governance in Indonesia and OECD

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ABSTRACT

A study in corporate governance by the Asian Development Bank supported the view that poor corporate governance was one of the major contributors to the build-up of vulnerabilities in the East Asian countries, including Indonesia, and that finally led to the financial crisis. The financial crisis has awakened investors to the fact that they need protection for their investment. There is a growing concern emerged with a great profile regarding the Islamic principles of corporate governance. A major ethical component of any economic activity in Islam is to provide justice, honest and fairness and to ensure all parties their rights and dues. Islamic economy has progressed a great deal during these last two decades with impetus as an important concern in developing an Islamic corporate system. This paper is an attempt to discuss the nature, applications and comparison of Islamic principles of corporate governance (IPCG) with conventional principles of corporate governance considering special reference to Organization of Economic Cooperation and Development (OECD) and Indonesia. After the discussion, it can be concluded that the dimension of Islamic perspectives of corporate governance has broader horizon and cannot compartmentalize the roles and responsibilities in which all actions and obligations fall under the jurisdiction of the divine law of Islam whereas, the OECD principles implements a firm with six different issue and obligations. . Implementation of corporate governance in Indonesia should consider the role of "Syariah Islam" for business and Accountability not only to stakeholders but also to God, the ultimate owner. Adoption of the principles of corporate governance in Indonesia should take into account the existence of domestic legal culture otherwise it will fail in its implementation.

Keyword: corporate governance, islamic principles, conventional principles, accountability, Disclosure and transparency, OECD, applications and comparison.

INTRODUCTION

'Verily, in the creation of the heavens and the earth and the alternation of night and day, are Signs for people of inward understanding who remember Allah, standing and seated, and upon their sides, and ponder as to the creation of the heavens and the earth: Our Lord! Not for naught didst thou create this . . .' (Quran 3: 190-191).1

The South East Asian financial crisis has put Indonesia into the worst financial crisis in its history as a nation. The local currency, the rupiah, depreciated almost 80 percent due to the crisis. The banking industry then collapsed. The collapse of the banking sector was followed by the corporate sector. The crisis also triggered a political and social crisis. There are many factors that can be blamed as the reasons for the financial crisis in Indonesia. Many studies in Indonesia showed that the most likely reason for the crisis was liberalization in the financial market. This liberalization commenced in 1988 when the government reformed the banking regulations. The policy in the banking sector has increased the corporate sector's access to domestic and foreign private capital. As the government applied the free capital flow system, the private companies then borrowed foreign capital without any restrictions. As result, the bulk of the private capital in the form of borrowings came in through banking system and private sector.

Inherent instability in the international financial market, often stemming from herd mentality and contagion effects, has also contributed to the financial crisis in Indonesia. The financial crisis has destroyed the financial system in Indonesia. Most banks and corporations were experiencing financial distress. Domestic financial institutions such as the banking sector and capital market are unable to inject corporations with fresh funds to deal with the shortfall in cash flow. According to Miskhin, the financial system of a country such as Indonesia, should be restarted so that it can resume its job of channeling funds to those with productive investment opportunities. The big problem for Indonesia's financial system is that it requires international investors to supply funds. The financial crisis in East Asia, including Indonesia, has brought corporate governance issues to the attention of the investors.

In the context of globalization, a more worrying threat is to Islam's benevolent actual and potential influence in the world (Tinker, 2004). We hope here to indicate to those of alternative religious persuasions, including those who put their faith in secularism and atheism, that Islamic principles may beneficially and variously challenge, enhance and refine their positions (cf. Abdel Haleem, 1998, p. 10; Gallhofer et al., 2000; Gallhofer and Haslam, 2004).2 Consistent with Gallhofer et al. (2000) and Gallhofer and Haslam (2004), a concern of this paperis thus to acknowledge the value of insights from a variety of cultures and value and belief systems for the development of accounting and governance systems.

The debate of corporate governance emerged as a great profile and of critical interest since the mid-1980s attracting a great deal of attention for the practitioners, communities as the managers, shareholders, investors, regulatory agencies, as well as in the academic research (Abu-Tapanjeh, 2006). The corporate governance is not only one of the main principle in running a firm successfully but also it ensures security confidence by monitoring and controls the operation of the firm. In this present business environment with diverse cultural background, the principles of corporate governance cannot be applied for all propositions. Thus need rigorously to adopt purposefully and implement new corporate rules and regulations that are more robust in the face of rapid financial innovation. This implies that good corporate governance is not just comply with hard and fast rules but also seen as guidelines for a supervisory framework of different environmental structures. Corporate governance need to become principle based, rather than being based on rules and regulations (OECD, 2004). This issue is well addressed by different committees around the world and has been repeated and renovated again and again by business committees and business leaders. These core concerns triggered in forming global reports on Corporate Governance. Hence, the Organization for Economic Cooperation and Development (OECD) principles endorsed by (OECD) ministers was born in 1999 and since then with its sound financial system became an international benchmark for policy makers, investors, corporations and other stakeholders.

The call for principles of corporate governance is not something new and alien to Islam. The Islamic financial system has thrived for centuries during the heyday of the Muslim civilization, but with the infiltration of modern conventional economy leads to misplace the Islamic civilization. And such a way Islamic economic developed as a social discipline in response to this environment. Although Islamic economy do perform mostly the same functions as conventional economy, there is always a distinct unique form of differences between both the principles implement. In fact, the primary feature of Islamic economy is to give just, honest, fair and balanced society as envisioned to Islamic ethical values and rules. (Ahmad, 2000; Mirakhor, 2000; Warde, 2000), expressed that Islamic business is always characterized by ethical norms and social commitments, grounded on ethical and moral framework of the *Shariah*. (Asyraf, 2006) herewith underpinned nicely that these *Shariah* injunctions interweave Islamic financial transactions with genuine concern for ethically and socially responsible activities at the same time as prohibiting involvement in illegal activities or those which are detrimental to social and environmental well-being. Khalifa (2003) also describes Islamic economics as it is Godly, ethical, humanly, and moderate and balanced. Therefore, all forms of exploitation are prohibited in Islamic business system and should underpin with the ethical rules of *Shariah*.

Many Islamic concepts or principles in the Quran and in the words and actions of the Prophet, such as *Tawheed* (Unity of God), *Khilafah* (vicegerency), *Umma* (community), *Adl* (justice), *Ihsan* (kindness), *Hikma* (wisdom) and *Tawadu* (modesty), carry substantive implications concerning the relationship between humankind and the natural environment. And the Islamic *Sharia* that guides Muslims reflects such concerns (Al-Qaradawi, 2005a). Insights from the life and sayings of the Prophet Muhammad enable us to 'construct an authentic Islamic environmental ethics and open a wide avenue of creative and innovative solutions in the contemporary context' (Denny, 1998).

Contemporary Islamic finance, banking and accounting practices and institutions have indeed been described as 'ideologically driven by liberalism and the common opposition to socialism that Saudi Arabia and the US shared' (Wardi, 2005, p. 43). Many ostensibly Islamic financial institutions and the research driving them are funded by oil-rich Gulf States, especially Saudi Arabia (Choudhury,

1986).3 Consequently, cooperation between Muslim businessmen and experts in Western business environments to promote and operate financial institutions under the banner of Islam manifested. The UK and US, rather than the Middle East or the Islamic world, became the centres for Islamic financial organizations and research, not denying the significant role played by large Muslim states such as Malaysia and Indonesia in promoting Islamic finance globally (Wardi, 2005). Islamic finance, especially banking, has today become one of the fastest growing financial sectors globally (Rad, 2006).

A study in corporate governance by the Asian Development Bank supported the view that poor corporate governance was one of the major contributors to the build-up of vulnerabilities in the East Asian countries, including Indonesia, and that finally led to the financial crisis. The financial crisis has awakened investors to the fact that they need protection for their investment. In this matter, studies by La Porta et al show some relationship between legal protection and the existence of corporate governance. La Porta et al concluded that legal protection and large investors are complementary in an effective corporate governance system. Investor protection becomes very important in Indonesia, as there is potential and actual expropriation of minority shareholders and creditors by controlling shareholders. In Indonesia, investors in public listed companies are minority shareholders which are very powerless compared to the majority shareholders. Another issue relating to investor protection and corporate governance is that investor protection encourages the development of financial markets.

As part of the IMF program, Indonesia is requested to apply good corporate governance in all sectors, especially for listed companies, banks and stated owned enterprises. The OECD Principles of Corporate Governance have been suggested to be adopted. The government then established the Indonesian Corporate Governance Committee. This committee has introduced the Indonesian Code for Good Corporate Governance. The purpose of this study is to examine the effectiveness of adoption of the OECD Principles of Corporate Governance by public listed companies in Indonesia.

The main objectives of this study are to briefly discuss the current state of corporate governance practices at the conventional economy and to establish the measurement of good corporate governance at the functional level and how far this approach can ensure the relativity with the Islamic corporate governance. This study describes a radically different approach focusing the similarities and differences of conventional corporate governance from the Islamic perspective. The researcher referred the principles of corporate governance (OCED) 2004, for the purpose of this study. It is done so, since these principles were so sound that it was immediately adopted by many well profounded companies and organizations and soon became a benchmark for identification of good elements all over the world. Therefore, this paper is an attempt to bring a comparative position and to analyze the similarities and differentiations of the revised OECD principles and its annotations to the Islamic perspective.

THE PROBLEM OF CORPORATE GOVERNANCE IN INDONESIA

Islamic principles help problematise the dichotomy sacred–secular (see Lewis, 2005). Hence, by intention, Islamic law is prescriptive in a holistic sense including in relation to accounting. The holism of Islam, evident in the *Tawheed* principle, and the concern to look after the Earth, are suggestive of a macro-level governance, incorporating planning and control, and associated accountings. At the same time, the need for attention to detail and co-ordination would suggest derivative systems of governing and associated accountings at the more micro-level.

From the financial point of view conditions in most listed companies in Indonesia are very bad. Firstly, almost all listed companies in Indonesia are overvalued. The market value has been determined to be 90 percent by the growth expectation and only 10 percent based on current earning stream or the ability of the company to generate a net profit. Secondly, the healthiness of the financial structure of listed companies is not quite good. Most of the listed companies outside of banks rely on debt financing with debt to equity ratio at 10:1. In normal financial conditions the debt to equity ration should be less than 5:1. This kind of financial structure has resulted from the effects of the financial crisis and caused listed companies to experience financial insolvency. The financial crisis has caused their assets to become insufficient to cover the debts. One of the reasons for the failure to deal with the effects of the financial crisis in Indonesia is the heavy practice of corruption, cronyism, collusion and nepotism. A Survey by independent organizations in this area shows that the level of corruption and transparency in Indonesia is the worst.

The problem facing sound corporate governance in Indonesia is the concentration of ownership, either in private or listed companies or the government control over the state owned enterprises. A survey of the Asian Development Bank in corporate management and control of public listed companies and conglomerates in Indonesia showed that concentration of ownership in most of

public companies is in the hands of several families. The dominant conflict in the implementation of corporate governance is between controlling shareholders and minority shareholders. In Indonesia, since the controlling shareholder or families control the management, the position of minority shareholders then becomes very bad.

All group companies in Indonesia establish a holding company with the purpose of holding several sub holding companies. Each of these sub holding companies then controls several operating companies in various sectors, such as banking, management, services, manufacturing and other activities. This kind of structure assists the founding family in obtaining a clearer picture of their business, but often without any transparency. The other fundamental problem of corporate governance in Indonesia is cross shareholding practices. Cross-shareholding in Indonesia has a negative impact on fair business treatment as it may create a monopoly in certain areas of business. Some people in Indonesia are reluctant to apply good corporate governance if this will have the consequence that the benefits such as monopoly of the companies with cross-shareholding will be missing.

In this respect, Al-Qaradawi (2000) advocates imposing constraints on the activities of large multinational or transnational companies so that overall their activities are channelled more towards what is deemed the social good. Within the limits or constraints (maintaining balance) there is a positive notion of enhancing or cultivating the environmental (including the social) and Islam places a value here on the eco-system, general flora and fauna, spirituality, being happy in one's submission to God, wisdom, prosperity, wealth, mercy (distinct from harshness) and justice (distinct from oppression) (*supra*). These desiderata imply a governance system implicating constraints and involving inducements and encouragements, with associated accountings at the various levels of the system. Islamic community principles are suggestive of a system of informing and disclosing to the *Umma* that is explicitly orientated to the public interest (*Istislah*), here seen integral to a broad ranging interest in the safeguarding and cultivating of the environment. The community principles encompass a governance or management project or a set of such projects with associated accounting implications at the various levels.28 In Islam, God demands that society should try to put in order a system whereby people are encouraged to do good and stay away from the bad (Begader et al., 2005).29 Thus there is a sense of collective as well as individual responsibility. This principle needs also, therefore, to be reflected in accounting at the various levels (see Ibrahim, 2000, p. 55).

It is not difficult to envisage accounting's significance through an Islamic lens on governance. Accountability to God and the notion of people having an account book with God are central tenets and presumptions of Islam (see, for instance, Quran 6: 5: 'Not a leaf falls but with His knowledge: there is not a grain in the earth's shadows, not a thing, freshly green or withered, but it is (inscribed) in a clear record'). Several commentators indeed stress that there is a strong emphasis on accountability in Islam (Omar Naseef, 1998; Lewis, 2001; Maali et al., 2003). Further exploration does suggest that the accountant, and hence accounting, is actually given a very key role – and one that reflects a more holistic notion of accounting than is conventional today – in relation to the Islamic principle of Trusteeship.

The *Muhtasib's* role in respect of accountability in an Islamic society, therefore, was not limited to technical and financial traditions. It was a social role, whereby the *Muhtasib's* accountability extended to making sure that *Sharia's* social rules in respect of *Umma's* welfare and interests were enforced and Corporate governance characteristics albeit playing different roles in ensuring companies success are ultimately the only responsible role affecting the business economy. (Van Den Berghe, 2001), state that performance is finally the outcome of many interlinking factors where corporate governance is the only one possible element within the whole set of performance drivers.

In fact, the term "corporate governance" has gained prominence only during the last two decades (Zingales, 1997). This terminology clearly had its origin from a Greek word "kyberman" which means to steer, guide or govern. This passed on from Greek to Latin word as gubernare and the old French "governer", but this word has been defined in different ways by different organizations or committees, according to their own ideological concerns. The OECD has defined it as the "set of relationships between a company's management, its board, its stakeholders and other stakeholders" (OECD, 1999). Mr. Wolfensohn (Wolfensohn, 2001), World Bank President, has gone a step further by explaining that corporate governance needs to be "fairness, transparency and accountability". Dyck (2000) also describe in adding this argument that corporate governance is broadly the complex set of socially defined constraints that effect the willingness to make investments in corporations in exchange for promises. Furthermore, Dalton et al. (2003) argued that agency theory is the theoretical basis of most of the research on corporate governance, they suggest the need to consider other theoretical ways of examining the relationship and propose a substitution theory approach which considers a range of governance mechanisms. Here it would be worth noting to quote Hakim (2002); he explains corporate governance as, "In the practical sense, corporate governance involves the nuts and bolts of how

corporations should fulfill their responsibilities to their shareholders and other stakeholders. Corporate governance is the mechanism by which agency problems of corporation stakeholders, including the shareholders, creditors, management, employees, consumers and the public at large are framed and sought to be resolved. Transparency, accountability and adequate disclosure are three essential ingredients in corporate governance". Hence, therefore, it can be concluded here that corporate governance is a set of mechanism that helps in confirming, with fair and just dealing to all the stakeholders and to strengthening transparency and accounting.

Prior studies of Islam and accounting have tended to focus on the following: accounting issues in relation to the calculation of Islamic *Zakat* (the financial sum to be given to the needy or worthy, a pre-determined rate applied to the value of net assets that cannot be altered by the government, Ibrahim, 2000); the implications for accounting of the Islamic prohibition of interest or usury; accounting in countries substantively influenced by Islam vis-`a-vis global accounting harmonisation projects (although many of these do not specifically consider the Islamic dimension); and, Islamic concerns with social accountability in relation to social accounting (Abdel-Magid, 1981; Abdul-Rahman & Goddard, 2003; Adnan & Gaffikin, 1997; Allam, 1997; Askary & Clarke, 1997; Baydoun &Willett, 1994, 1997, 2000; Gambling & Karim, 1986, 1991; Hamat, 1994; Hamid, Craig, & Clarke, 1993; Haniffa, 2001, 2002; Haniffa & Cooke, 2005; Haniffa&Hudaib, 2002; Haniffa, Hudaib & Mirza 2002; Hussain et al., 2002 Hussain, Islam, Gunasekran, & Maskooki, 2002; Ibrahim, 2000, 2001; Karim, 1999, 2001; Lewis, 2001; Maali, Casson, & Napier 2003; Mirza & Baydoun, 2000; Pomeranz, 1997; Rahman, 1995; Simpson & Willing, 1996; Taheri, 2000; Triyuwona & Gaffikin, 2001).

A most important concept of Islam's philosophy of nature is the central Islamic concept of *Tawheed* (Unity of God) (De Chatel, 2003; Omar Naseef, 1998, p. 13). The concept implies the unity and equality of all God's creations in the worship of God and their equality as partners in terms of the due respectful recognition of the existence of all and the due appreciation of interdependency and interconnectedness between all. The latter is properly deemed reflective of mutuality and a universal common good to which all contribute (Al-Qaradawi, 2000; Begader, El-Sabbag, Al-Glayand, Samarrai, & Llewellyn, 2005; De Chatel, 2003; Quran, 16: 48–49; see also Quranic verses 13: 15; 59: 1; 64: 1; 17: 44).11 There is thus an equilibrium ruling the natural world, and all God's creations are understood to be in balance or in harmony in this respect, having been created in a measured way or by measure, a measure not to exceed or to fall short of (Al-Qaradawi, 2000; Begader et al., 2005; Hobson, 1998; Taib, 2002):

'Verily, all things have We created in proportion and measure' (Quran 54: 49).
And:
'The sun and the moon are made punctual. The stars and the trees adore. And the sky he hath uplifted. And He hath set the measure. That ye exceed not the measure. But observe the measure strictly, nor fall short thereof' (Quran 55: 5–9).12

Good corporate governance has long been considered a crucial role for stakeholders in the business environment. Though the goal of corporate governance differs from one firm to another, or from one country to another, the main important concern is to impetus a good code of mechanisms to uplift and govern the organization. But with the current business pressure, corporate governance structure changes very fast. The financial innovation and globalization forcing the executives to adopt rigorous re-evaluation of corporate governance principles. Meyer (2004) says that a systematic governance means adjusting the signals with an organization such that staff automatically do the right things, without the need for oversight. Sound corporate governance practices have become critical to worldwide efforts to stabilize and strengthen good capital markets and protect investors (Darman, 2005).

Many studies exist linking good corporate governance with better performance. There is empirical evidence to suggest that countries that have implemented good corporate governance measures have generally experienced robust growth of corporate sectors and higher ability to attract capital than those that have not (SECP, 2005). Fianna and Grant (2005) explains that good corporate governance helps to bridge the gap between the interests of those that a company, by increasing investor confidence and lowering the cost of capital for the company. Furthermore, they also add that it also helps in ensuring company honors, its legal commitments and forms value-creating relations with stakeholders. Coles et al. (2001) and Durnev and Han (2002), also found that companies with better corporate governance enjoy higher valuation. However, there is a growing argument that corporate governance still needs to be renovated and revised. Hence, it can be concluded that issue of good corporate governance is still open for discussion.

OECD PRINCIPLES OF CORPORATE GOVERNANCE

The OECD Principles of corporate governance originally adopted by the 30 member countries of the OECD in 1999 have became a reference tool for policy makers, corporations, institutional and regulatory frameworks and others. It also provides practical guidance and suggestions for stock exchange, investors, corporations and other profound organizations of the world other than OECD member countries. Daniel (2003) states the reasons why one should care about the quality of corporate governance, as firstly, it leads to increased economic efficiency and growth, it improves the use of capital, and encourages foreign direct investment. Secondly, it lowers the risk of crisis and in the case of an external shock it improves the robustness of the economy. Thirdly, it is crucial for the legitimacy of a market economy. Henceforth, to ensure consideration of these standards, the OECD has oriented discussions including some main categories of the principles. The OECD began a review of the principles in 2003 considering the recent changes and developments and after an extensive review the process led to adopt revised and reviewed OECD principles of corporate governance in April, 2004. The revision principles not only reflect the experience of OECD countries but also the emerging and developing economics. The revised principles are non-binding in nature and it lays up to the governments and market participants to decide for their own framework. It also confirmed the adaptability of the principles as a reference in varying legal, economic and cultural contexts. "Corpo rate governance is the system by which business corporations are directed and controlled.

In 1996, the Organization for Economic Cooperation and Development (OECD) formed the Business Sector Advisory Group and a task force to refine a set of basic principles of good corporate governance. According to the report of this advisory group, to achieve good corporate governance, it is required to have combination of regulatory and voluntary private actions. This advisory group noted that government interventions in corporate governance are the most effective if consistently and expeditiously enforced. The interventions of the government should focus in the following issues:

(i) Fairness: protecting shareholders rights and ensuring the enforceability of contracts with resource providers;
(ii) Transparency: requiring timely disclosure of adequate information on corporate financial performance;
(iii) Accountability: clarifying governance roles and responsibilities and supporting voluntary efforts to ensure the alignment of managerial and shareholder interests, as monitored by a board of directors-or in certain nations, a board of auditors-with some independent member;
(iv) Responsibilities: ensuring corporate compliance with other laws and regulations that reflect society's values, including a broad sensitivity to the objectives of the society in which corporations operate.

The corporate governance specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spell out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structures through which the company objectives are set, and the means of attaining those objectives and monitoring performance" (OECD, 2004). The following are the main areas of the OECD principles and its annotation:

Principle 1: **Ensuring the basis for an effective corporate governance framework.**

Annotation: The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

In Indonesia, protection to shareholders rights has been provided under the Indonesian Code. Under this code the rights of the shareholders shall be protected, and accordingly, the shareholders shall be able to exercise their rights pursuant to appropriate procedures that have been adopted by the companies. This code suggests that it is necessary to apply regulations having the force of law for the procedures to protect the rights of shareholders.

Principle 2: **The right of shareholders and key ownership functions.**

Annotation: The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

Beside the rights of the shareholders, the Indonesian Code also provides a principle that deals with shareholders responsibilities. According to this principle, the shareholders owning a controlling interest in a company shall be mindful of their responsibilities as shareholders when they exercise any influence over corporate management, whether by the exercise of their voting rights or otherwise.

Principle 3: **The equitable treatment of shareholders.**

Annotation: The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunities to obtain effective redress for violation of their rights.

Equitable treatment of shareholders in Indonesia has been accommodated under the principle of the shareholders' rights. This principle suggests that shareholders of the same kind of shares shall be treated equitably based on the principle that shareholders of the same kind of shares have the same equitable position in the company.

Principle 4: **The role of stakeholders in corporate governance.**

Annotation: The corporate governance framework should recognize the rights of stakeholders established by lawor through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

The principle of corporate governance in Indonesia regarding the rights of stakeholders mentions that the rights of stakeholders under the prevailing regulations having the force of law and /or pursuant to any contracts entered into by the company with customers, suppliers, creditors and surrounding community,
shall be respected. For this purpose, the principle suggests that the stakeholder shall be provided with an opportunity to monitor and offer inputs to the company's board of directors.

Principle 5: **Disclosure and transparency.**

Annotation: The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

As in the OECD Principles, the Indonesian Code contains a principle that the company shall disclose material information through its annual reports and financial statements to shareholders and the relevant government authorities in accordance with the prevailing regulations, in a timely, accurate, understandable
and objective manner. This principle stresses also the importance of materiality in the disclosure of information and other sensitive issues in the information and also information regarding implementation of the principles of good corporate governance.

Principle 6: **The responsibilities of the board.**

Annotation: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and board's accountability to the company and the shareholders. The main theme of the above principle lies in four basic principles. Firstly, the mechanism of business ethics, secondly the mechanism of decision making, thirdly in adequate disclosure and transparency and lastly the mechanism of book keeping and final accounts. These OECD principles are so sound that even the non-members of OECD are implementing and adopting. As Morck (2005) states that the soundness of these principles has been proved by its adoption all over the world the next section will discuss the Islamic view of corporate government from the Islamic perspective.

Adoption of the OECD Principles in Indonesia follows the two-tier system in the boards of the companies. According to the Indonesian Code, the board of commissioners shall be responsible and shall have the authority to supervise the actions of the directors and shall give advice to the directors when required. A new development in corporate issues in Indonesia is the establishment of some committees to support the implementation of the task of the board of commissioners. The Indonesian Code suggest that the following committee shall be established in the company:

CORPORATE PRINCIPLES FROM ISLAMIC PERSPECTIVE

Islamic business principles

The Islamic religion relates directly to all spheres of life, including how to conduct the trade and commerce. *Shariah* covers not only religious ritual, but also many aspects of day-to-day life, politics, economics, banking, business or contract law, and social issues (Wikipedia, 2005). The holistic and social emphasis of Islamic teachings engendered the establishment of Islamic institutions in the peak period of Islamic civilization (the seventh and eighth centuries), whose role was to maintain the cohesion of the Islamic society as a whole and ensure the accountability of trade and business. One of these institutions to regulate the market was *al-Hisba*, whereby society was to be protected from fraud and exploitation (Wilson, 1997). The *Hisba* office was established under the Abbasids (seventh and eighth Centuries) for the 'promotion of good and the prevention of evil' (Gambling and Karim, 1991, p50).7 It seeks to reinforce the basic elements of Islam including the equality of all Muslims and the outlawing of discrimination on account of race, gender, or class. The *Muhtasib* (accountant in Arabic) was appointed to ensure that market trading and traders in the area coincided with the Sharia (Gambling and Karim, 1991). This included duties to protect the natural environment,8 ensure prevention of monopolies, price controls and well-maintained public utilities and government resources (Gambling and Karim, 1991). Consequently, the role of *Muhtasib* was mainly to ensure justice in society, encompassing both spiritual and secular dimensions (Gambling and Karim, 1991; Murtuza, 2000).

For Gambling and Karim (1991), the concept and role of *Hisba* and *Muhtasib* in early Islamic governance models provides inspiration for accounting today, contributing to debates surrounding a form of social accounting where business accountability include its 'externalities' and where faithful and transparent corporate reporting on business's financial, social and environmental impacts are called for. The concepts can also contribute to debates surrounding the role of accountancy and international regulatory bodies, whose role should be to ensure that business organizations are operating in line with the public interest (Gambling and Karim, 1991). A reflection on accounting's role in Islam provides for a departure from or a challenge to accounting's role under a narrow capitalism. According to Gambling and Karim (1991, p. 2), Western capitalism's efforts to divorce accounting from moral considerations are not realistic, as 'amoral accounting is neither essential nor desirable—and is, in fact, strictly impossible'. Tinker (2004, p. 454) also argues that accounting in the liberal and capitalistic context has 'assumed a role of efficiency and control to ensure and impose the injunctions of capital accumulation and market relations'.

Business transactions had long been in practice since the early days of Islam, but with the colonization of the western countries, the social environmental discipline gets inflicted (infected) with the western ideology. Sequently, Islamic economics developed as a social disciples in response to this environment, with the aim of establishing or restoring Islamic authority in areas where Muslims increasingly were falling under the sway of western ideas (Ahmad, 1984; Kuran, 1995; Nasr, 1984). Business needs to be arranged and organized in order to contest the outcome. Lewis (2005) explains that, how firms are organized, directed and controlled, in short what is now called corporate governance, is one aspect of this broader agenda. Yet, despite a considerable interest in the topic of corporate governance recently by organizations such as the Islamic Development Bank (Ahmad, 2000; AAOIFI, 2003; Chapra, 1992), little is written on corporate governance structures and there is not even as yet a unified expression in Arabic to represent the meaning of corporate governance (Sourial, 2004). Albeit this statement, corporate governance in Islamic law provides and embodies a more larger and vast guidelines with encompassing duties and practices as on how to deal with economic transactions up to the moral conduct of a Muslim without even defining the modern world corporate governance as such Islamic laws impetus corporate governance in every individual actions of Muslim up to the social environment. Hence, the following is a discussion as how the OECD principle of corporate governance can be seen in Islamic business activities by taking these following principles and how it governs the conduct of business.

Business ethics

The ethical and moral emphasis, however, usually falls short of employing critical theoretical dimensions that question dominant capitalist ideology and the nature and emphases of Western accounting standards. The Islamic accounting literature, for instance, is silent on the role of capitalism and Western imperialism in creating conditions of extreme deprivation and poverty within and outside the Muslim world. Further, the research frequently attempts to link Islamic accounting to today's

contemporary practices of accounting in the Western, capitalistic context. Some papers go further to claim that there are no significant differences or obstacles hindering Muslims from embracing current Western and capitalistic accounting practices (see Zaid, 2000; Pomeranz, 2004).12 Further, the literature scarcely problematises the provision and promotion by Western, multinational banks of products under the banner of Islam, considering the controversial nature of multinational banks. For instance, Pomeranz (1997, p. 123) celebrates the opening by Citibank of the first Islamic banking subsidiary in Bahrain holding it an 'eventual realization of substantial benefits by both Western and Islamic banks'. Further, for Pomeranz (1997), the move towards market policies and privatization in many Islamic countries are serving the needs of Islamic banking. Such tendencies in Islamic accounting research exemplify contradictions in this research between its normative ethical claims and its practical recommendations and findings.

Muslims are directed to conduct their business in accordance with the *Shariah* rules, i.e., to be fair, honest and just toward others. Accumulating wealth of oneself is allowed under the constraint restrictions of Islamic ethics. Saeed (1996) explains that, "wealth is considered a trust and a test, where failure to use it wisely, especially to alleviate the hardship of the poor is detrimental to the person who holds that wealth". And above all, the main virtue is of prohibition of *riba*. Haqqi (1999) states that one of the most important prohibitions against misuse, of wealth is prohibition against *riba*, which is generally translated to mean "usury" or interest. This statement impetes that the virtue of Islamic business is fair, and honest dealing, where all kinds of exploitations are prohibited. Lewis (2005) rightly points out here that, "Islam always encouraged trade and commerce as long as it is conducted within the framework of Holy Quran, and the word of Allah as revealed to his prophet Muhammad (PBUH).

Decision-making

The holy Quran clearly mandates the principles, which govern the Muslims' lives. These principles were implied and compiled to Muslim since the early days of the Islamic state. The ethical notion of corporate governance assumes a more broader and holistic significance in Islam. The dimension of governance in all manifestations is essentially about decision making. Islamic ethics of decision making not only comply in the hands of superior officials but also extends the responsibility to fulfill with obligations beyond shareholders, clients, financiers, suppliers, customers, employees, embracing within spiritual religious bounty. An employee would be expected to contribute his or her knowledge to the formulation and implementation of the organizational vision and consultative procedures should be applied to all affected, i.e., shareholders, suppliers, customers, workers and the community (Baydoun et al., 1999).

Islam mandates human beings as trustees of Allah in all situations and the ultimate trust is to keep in Allah, the ultimate owner of everything in this world. Muslims are taught to maintain and strengthen good relationship with superiors, clients and the management conforming with the divine norms and rules, hence inspired the whole community with values of truthfulness, fairness, tolerance and justice, etc., this shows that the Islamic institutions imply decision-making in a different and more broader ways than conventional institutions do. This is written in many verses of the Holy Quran and Hadith.

"And consult them on affairs (of moment). Then, when thou has taken a decision, put thy trust in Allah" (Al-Imran 3.159).

"Those who respond to their Lord and establish regular prayer; who conduct their affairsby mutual consultation; who spend out of what we bestow on them for sustenance" (Ash- Shura, 42.38).

Abu-Hamzah Anas bin Malik (RA) reported that the prophet believers (in Allah and in his religion) until he loves for his brother what he loves for himself (Al-Bukhari & Muslims). Islam introduced improvements in accordance with the moral principles enunciated by the Holy Quran (Stork, 1999).

These above verses clearly emphasize on consultation and whom to consult. The best benefited ways to whom to consult are those good men who respond to God and fear God, and who can conduct fair mutual justice with equal importance to all. Thus, this conveys the Muslims to "live true in mutual consultation and forbearance, and rely on Allah. Islam encourages the participants to work together freely and frankly when arriving at decisions (Shaikh, 1988). Islam also demands the whole group to participate in decision-making.

Islamic principles that represent a core element of corporate governance is that of an institution called Hisbah established under the Abbasides (750 a.d. onwards) which ensures compliance with the *Shariah* requirements, particularly in the business affairs. Duties like correcting weight and measures, fair trading rules, checking business, frauds, auditing illegal contracts, keeping the market free, and preventing hoarding of necessities were carried out by this office as stated by (Abdul Rahman, 1998).

Therefore, since the early days of Islam, corporate governance is embedded in an appropriate ethical environment fulfilling the bounty of *Shariah*. The mode of corporate governance is hence more vast and bigger in dealing with that of the OECD principles, where BOD and the senior manger are entitled to implement the decision-making.

Disclosure and transparency

As Bapepam and the Jakarta Stock Exchange are very strict in the implementation of regulations regarding disclosure and transparency, the level of compliances is very high. Failure to comply with this regulation will result in an administration penalty such as fine for 1 million Rupiah a day or trigger de-listing. All listed companies currently have appointed a corporate secretary. In many cases a member of the board of director carries out the function of corporate secretary. The existence of a corporate secretary in listed companies is quite effective, as it may encourage the listed companies in Indonesia to comply with the disclosure requirements.

In Islamic economy, accountability is entitled to produce a true and fair disclosure and transparency. Accountability is first of all to Allah. The fundamental concept of Islamic accountability is believed that all resources are made available to individuals in a form of trust. Hence true disclosure of financial facts, and accurate information should freely available to the users. Another important point involved in disclosure is to provide the users adequate information which needed for sound financial decisions. This will lead in paying accurate *Zakah* which is the third pillar of Islam. Accuracy in a sense, involves an aspect of fairness and just system. This can help in making economic and business decisions consistent. This fundamental is a powerful ethics in Islamic accounting system and helps in promoting proper disclosure and transparency in any business dealing.

Book keeping and final account

Islam encourages to deal business ensuring fair and just financial transaction between each other and the ultimate accountability to Allah. Al-Quran clearly shows us the moral ethics of dealing this principle, as

"O you who believe! when you deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing and let a scribe write down faithfully as between the parties" (Al-Quran, 2.282).

"And if you are traveling and cannot find a scribe, then there be a mortage taken… And do not conceal any evidence for the whoever hides it, surely his heart is sinful, and Allah is all knower of what you do" (Al-Quran, 2.283).

"We shall set up justice scales for the day of judgment, not a soul will be dealt unjustly in the least and if there be (no more than) the weight of mustard seed, we will bring it (to account), and enough are we to take account" (Al-Quran, 21.47).

In Islam, dealing with corporate governance is not only just the designation or his position and power but also his internal moral enthusiasm to fulfill and carry out the conduct of the job within the bounty of Islamic *Shariah*. It can be also seen that the responsibility are not entitled to those only who encompass the business power but also to all those stakeholders who are involved and related with the organization. Corporate governance in OECD entitled the power of decision making and participation of deeper internal business dealings to those limited persons holding higher designation as BOD and senior management authorities whereas, in Islam, those whoever related stakeholders of the organization are given full rights and responsibility to participate and conveys their thoughts and ideas in reforming better corporate governance. And above all Islam was made accountable not only to stakeholders, but also to God, the ultimate owner and authority. These powerful moral ethics help in promoting fair, just and honest business dealing.

COMPARISON OF ISLAMIC CORPORATE GOVERNANCE PRINCIPLES WITH OECD PRINCIPLES

Critique of Islamic Banking and Accounting Practices

Critique of Islamic Banking

Islamic banking in the last two decades has grown and expanded globally after gaining support and endorsement from the oil-rich Gulf States (Henry and Wilson, 2005). It became a successful global phenomenon, existing in majority and non majority Muslim countries. And it is provided by both Islamic and non-Islamic banks (Iqbal, 1997; Murtuza, 2000; Pollard and Samers, 2007). There are now over 300 Islamic banks and financial institutions globally, with assets of roughly between $200 and $300 billion. Conventional banks in many Islamic countries have become Islamic banks to expand their client base. Further, 25% of Islamic banking and finance operates outside the Islamic world. Its global character was boosted by the creation of the Dow Jones Islamic Market Index in 1999, and the Dow Jones Citigroup Sukuk (Islamic Bond) Index in Kuala Lumpur in 2003 (Pollard and Samers, 2007).

Contemporary Islamic banking places the interest ban, albeit in theory, at the core of its activities and products (Kuran, 2004). This means that Islamic banks differentiate their activities and products from conventional ones in that they should share profit and loss with their depositors (Dar and Presely, 2000). Consequently, Profit Loss Sharing (PLS) is the primary concept that Islamic finance is built and marketed upon (Dar and Presely, 2000). PLS is a 'contractual arrangement between two or more transacting parties, which allows them to pool their resources to invest in a project to share in profit and loss'(Dar and Presely, 2000, p. 4). The most dominant financing techniques promoted by Islamic banks as specifically Islamic are *Mudarabah* (a partnership in profit between the provider(s) of labour and the providers of capital. Profit is shared as agreed by the two parties and the losses are borne by the provider(s) of funds), *Musharakah* (an investment based technique, each party contributing to a partnership's capital in equal or varying degrees, with losses shared in proportion to the contributed capital), *Murabaha* (the sale of goods at cost plus an agreed profit mark up) and *Qard Hassan* (loan repayments are made over a period agreed by both parties, with no profit accruing to fund providers) (Iqbal, 1997; Faysal Islamic Bank, 1999; Dar and Presely, 2000; Haniffa et al., 2002).

Islamic banks' failure to significantly employ PLS techniques is due to their recognition that they lack the skills to distinguish between good and bad investment opportunities (Kuran, 2004). They fear that if they employ PLS techniques to lending, they will make bad choices and end up with more losses than profits. In effect, the activities of Islamic banks promising interest free banking are described by a number of observers as 'merely a fiction' (El-Gamal, 2007). El-Gamal (2006a) explains that Islamic finance and banking in practical terms tend to end up replicating conventional products and innovations. El-Gamal (2006a) highlights a number of Islamic products provided by Islamic financial institutions (such as *Sukuk* or Islamic bonds) that are merely 'thinly veiled versions' of contemporary financial instruments with interest embedded in them. For El-Gamal, Islamic finance is not built from classical jurisprudence. Rather, it is a modification of conventional practice where that practice is deemed forbidden. Islamic banks are not distinguished by their social emphases or developmental dimensions either. In making loans, Kuran (2004) explains, Islamic banks employmainly financial criteria in decision making. As in conventional banking, Islamic banks pay little attention to non-financial considerations such as the health of future generations (Kuran, 2004; Newton, 2006).

In contrast to the social and developmental role assigned to Islamic banking in theoretical debates, contemporary Islamic banks scarcely prioritize long-term development projects over projects aimed at quick profits. They do not appear to provide the cash-poor with investment opportunities. Further, they show little sign of bias against projects with heavy social and environmental costs and are scarcely transparent or accountable to communities and customers left to trust the rulings of the Sharia Board (Kuran, 2004; Newton, 2006). Like conventional banks, Islamic banks are contributing to the rise in the debt culture without any significant focus on or prioritization of moral, social or ethical dimensions as emphasized in Islamic teachings (see Kuran, 2004; Patel, 2004; Newton, 2006). For Kuran (2004), the only difference between conventional and Islamic banking is in appearance: Islamic banks are managed by a religious council; their headquarters are full of signs of Islamic piety, veiled females and bearded males.

The contemporary market-friendly Islamic banking phenomenon has also gained the support of international organizations and Western governments. The World Bank has encouraged engagement with the Islamic Development Bank. Further, multinational oil and construction corporations have claimed employment of Islamic financial instruments in their Gulf State operations (Henry and Wilson, 2005). In 2004, US President Bush appointed the first Islamic finance scholar and advisor in residence

for the White House. Similarly, UK Prime Minster Brown proclaimed that he would like to make Britain the 'gateway' for Islamic banking (see El-Gamal, 2007; Pollard and Samers, 2007). The UK and the US have been pioneers, alongside Saudi Arabia, in funding and hosting conferences devoted to promoting and discussing regulations and operations of Islamic financial institutions (see Wardi, 2005; Dar and Presely, 2000).

Critique of the AAOIFI

The AAOIFI is a standard setting body based in Bahrain and established in 1997 (Maurer, 2002). According to the AAOIFI, its objective is to develop accounting and auditing 'thoughts relevant to Islamic institutions; prepare, promulgate, interpret, review and amend accounting and auditing standards for Islamic financial institutions and to carry out commissioning of research in the area of Islamic accounting and auditing' (AAOIFI, 2007). The organization claims that these objectives are carried out in 'accordance with the precepts of Islamic Sharia'. The objective of the standards is to increase market confidence in the activities of Islamic banks, render them comparable**,** and facilitate transfer of Islamic banking and finance practices across national and regulatory contexts (Maurer, 2002; AAOIFI, 2007). The AAOIFI's founders aimed to avoid inconsistencies between individual boards and help in developing new products (Lewis, 2001). Despite that for most Islamic financial institutions the AAOIFI standards are not mandatory, the AAOIFI has been successful in promoting its standards to Islamic financial institutions globally. By 2009, the AAOIFI will have issued ninety standards (Alchaar, 2007). In addition to standard setting, the AAOIFI runs programmes leading to an Islamic CPA certificate and certificates for Islamic auditors and Sharia Supervisory Board members. These are very popular amongst young Muslims seeking careers in Islamic finance (AAOIFI,2007; Alchaar, 2007).

Critique of AAOIFI's role and standards has addressed their emulation of Western capitalistic driven accounting bodies, their overall emphasis on technical and instrumental issues relating to interest prohibition and Zakah calculation and their role in legitimizing and promoting Islamic banking products and activities as Sharia compliant and interest-fee (Lewis, 2001;Maurer, 2002; Kuran, 2004; El-Gamal, 2006a, 2006b).

Despite the AAOIFI's claims to build its standards on the Sharia, the AAOIFI's standards have built significantly on standards issued by Western, international accounting bodies especially the IASC (International Accounting Standards Committee) (Maurer, 2002). Concerned with acceptance and transferability globally, the AAOIFI has developed its standards by drawing on the most dominant accounting and auditing practices in Islamic institutions (Lewis, 2001; Maurer, 2002). The focus of the AAOIFI's standards, furthermore, is largely limited to technical and instrumental concerns relating to the prohibition of interest and Zakah accounting (see Kuran, 2004; El-Gamal, 2006a). The technical obsession with the interest ban (Kuran, 2004) in the development of the Islamic standards counters the more enabling and emancipatory potential of Islam for accounting (*supra*). Instead, for Maurer (2002, p. 657), the objectives of the AAOIFI standards are the same as any other standards issued by international or local accounting bodies in the capital market: 'the provision of decision-usefulness facts for large investors'. The AAOIFI standards' emphasize the decision-usefulness criteria for self-interested wealth maximizers as well as the effectiveness, efficiency and global growth of the industry (see Alchaar, 2007). There is evidence of the AAOIFI's embracing of the spirit of the dominant capitalism and market ideology (Maurer, 2002).10 The AAOIFI failed to properly create an alternative culture of accounting informed by Islamic values and created a 'culture [that] constructed [the existing] a new' (Maurer, 2002, p. 662).

Further, for El-Gamal (2006a), the standardization of Islamic accounting through the AAOIFI has helped legitimize these standards as Islamic and reduce suspicion by Muslims as to their Islamic nature. For El-Gamal (2006a), Islamic financial products supported by AAOIFI standards are perceived by customers and users as mature, creating false perceptions in their minds about the true nature of Islamic banking and finance (El-Gamal, 2006a). This has reduced the pressure on Islamic banks and financial institutions to educate the public about the significant similarities between Islamic products and conventionalones (El-Gamal, 2006a).

A Comparative position of Islamic principles of corporate governance with the revised principles of OECD. Principle number OECD principles and annotation Islamic principles.

Principle number	OECD principles and annotation	Islamic principles
1	*The rights of shareholders and key ownership functions*	
	• Basic shareholder rights	• Property as trust from God
	• Participation in Decision-making at the general meetings	• Sole Authority is God
	• Structures and arrangements markets for corporate control	• Society as stakeholders
	• Ownership rights by all shareholders including institutional shareholders	• Accountability not only to stakeholders but also to God, the ultimate owner
	• Consultative process between Shareholders and institutional shareholders	
2	*The equitable treatment of shareholders*	
	• Protection to minority and foreign shareholders	• Just and fairness of value
		• Equitable distribution of wealth to all stakeholders and disadvantages members in the form of *Zakat* and *Sadqa*
		• Social and individual welfare with both spiritual and moral obligation
		• Sensation of Equalit
3	*The role of stakeholders in corporate governance*	
	• In creating wealth, jobs and sustainability of financially sound enterprises	• Islamic accountability to *Falah* and social welfare orientation
		• Haram/Halal dichotomy in transaction
		• Social & individual welfare from both spiritual and material
		• Consideration to whole community.
4	*Disclosure and transparency*	
	• Matters regarding corporation	• Accountability with *Shariah* compliance
	• Financial situation	• Socio-economic objectives related to firms' control and accountability to all its stakeholders
		• Performance, ownership and
	• Justice, equality, truthfulness transparency governance	
		• Wider accountability with written as Well as oral disclosure
5	*The responsibilities of the board*	
	• Strategic guidance	• Accountability not only to company or board or stakeholders but also to Allah the ultimate authority who leads to welfare and success
	• Monitoring of management	• Holistic and integrative guidance
	• Accountability to company and stakeholders	• Negotiation and co-operation
		• Consultation and consensus seeking for each decision with related stakeholders

CONCLUSION

The Indonesian Code of Corporate Governance is adopted from the OECD Principles of Corporate Governance. These principles were developed in the developed countries such as the United States, the United of Kingdom and other OECD countries. In these countries, there are no issues in the lack of law enforcement or weakness in regulations. In addition, people support the voluntary codes or informal codes such as the code of corporate governance. While in Indonesia, due to their experience during the last two-decades that the formal legal systems were not effective to maintain their rights, people give little appreciation to formal regulations. In the situation when formal regulations are not much appreciated, introduction of a voluntary regulatory code such as the code of corporate governance will be meaningless.

This study too has aimed to analyze the possible need of corporate governance from Islamic perspective with the world notable principles reviewed by OECD. It discusses above the current state of corporate governance practices at the conventional economy and established the measurement of good corporate governance at the functional level, compared from Islamic perspectives. Like any other civilization and religion, For the Moslem community, basically they are open to any new development as long as it brings benefit to the members. In listed companies, often a company is operated in accordance with "Syariah Islam". For instance, to fight corruption, Muslim people in Indonesia apply a "jihad program". Implementation of corporate governance in Indonesia should consider the role of "Syariah Islam" for business.

The Islamic principles considered are suggestive of a variety in accounting content at the macro- and micro-societal levels, whether in external or internal accountings. There is nothing to restrict the form of accounting: for instance, reflecting holism, and the principle of moderation the accounting would not be delimited to a financial or materialistic basis. From an appreciation of the *Tawheed* principle accounting might properly be concerned to monitor, report and act upon changes in flora and fauna and ecological phenomena more generally at a macro-level. These accounting conceptions, as such, are not restricted to Islam and are not new either as conceptions or as practices, although it may be reasonably concluded that they are not always so well operationalised, especially not in the way reflective of the deep respect for nature that is implied in *Tawheed*.

Islamic accounting regulatory bodies such as the AAOIFI should play the role of regulating business organizations in the interest of the public, equality, sustainability and social justice. Only then may the AAOIFI properly claim to operate and develop accounting standards according to Sharia.

Therefore, the recommended set of principles of OECD had long been existing since the early stage of Islamic civilization. But, with the globalization tendency and in filtering with the cultural, religious and social, business and political factors, lead to misplace the true ethos of Islamic civilization. Hence, in this present situation, the OECD principles have been successfully implemented and considered a very effective tool of corporate governance as compared to Islamic principles of corporate governance.

Finally, the problem of legal transplant of corporate governance in Indonesia is that the policy makers always ignore the importance of legal culture. Foreign codes of corporate governance work well in western countries because the principles of corporate governance are alive in their legal culture. These principles become part of the legal culture. Adoption of the principles of corporate governance in Indonesia should take into account the existence of domestic legal culture otherwise it will fail in its implementation.

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