

Corporate Governance Practice, Risk Management and Internal Control at Kedah State Zakat Board (LZNK)

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This research examined corporate governance, risk management and internal control at Kedah State Zakat Board at a professional level (LZNK). This study reviewed the practice of corporate governance, risk management and internal control that LZNK was practicing. The strengths and weaknesses of these practices were examined and subsequently some suggestions are addressed to LZNK with regard to corporate governance, risk management and internal control. Qualitative approaches are used where several respondents from LZNK and academics are interviewed, using a semi-structured tool and purposive sampling techniques. In addition, the review of key documents such as the Kedah State Zakat Board Enactment (Enactment 23) 2015 and the annual report of LZNK were also conducted. Several suggestions for improvements relating to corporate governance, risk management and internal controls in LZNK are recommended. These include submitting an internal audit report to the audit committee, initiating a governance code and the creation of a risk management committee – all actions required immediately.

Key words: *Kedah State Zakat Board, corporate governance, risk management, internal control.*

Introduction

This research examined the practice of corporate governance, risk management and internal control at Kedah State Zakat Board at a professional level (LZNK). Corporate governance, risk management and internal control are key elements that are closely interrelated in the context of governance itself (Ishak & Mohamad Nor, 2017). Governance covers all matters relating to administration, behaviour and risk management as well as internal controls. Good governance in an organization or company reflects that it has efficient business administration, good risk management, robust internal controls and commendable staff behavior. For public-listed companies in Malaysia, the Securities Commission (SC) has published governance and best practice codes (MCCG, 2017) as references and guidance to companies in charge. However, LZNK is not a company entity and in this study, researchers are studying the code or guidelines that LZNK applies to governance. When referring to MCCG 2017 issued and published by the SC, there are comprehensive guidelines on corporate governance and best practices that can be referred to and practiced by public listed companies in Malaysia. MCCG 2017 also addresses risk management, internal controls, internal audit function and board responsibilities.

Risk management is a very important process within an organization. This process is ongoing and always takes into account any risk-related factors (ASX, 2010). Risk management is very complex and requires strong collaboration from all parties within a company or organization (Subramniam & Carey, 2011; Tiwari, Shahbaz & Hye, 2013). The risks involved are both internal and external and range from little risk to maximum risk. Each department and unit within a company or organization have their respective risk profiles which begin with the introduction of each risk, level of risk and actions to reduce each of these risks. It is impossible to completely eliminate the risk but actions can be taken to reduce it. For a company or organization it is necessary to have a department or unit designated to coordinate risk management process by departments or other units. In the context of LZNK, researchers pay attention to risk management related to financial aspects, accounting reporting and internal controls. The risks associated with collection and distribution of zakat which is the main function of LZNK, are not included in the scope of this study.

Internal control is a very important mechanism in risk management and governance of a company or organization. Internal controls determine the level of risk management whether and whether they are at an appropriate or otherwise level. If internal controls work well and are complied with by all employees, then the level of risk management is good and correspondingly, company or organization governance is good. This study seeks to investigate and understand deeply the practice of corporate governance, risk management and internal control practiced by LZNK. Comparisons with Malaysian best practice such as Malaysian Code on Corporate Governance (MCCG, 2017) were conducted. Every aspect of

the elements of governance, risk management and internal control is considered and compared to MCCG 2017. Furthermore, the investigators dismantle all the strengths and weaknesses that LZNK has. Despite differences in governance practices, risk management and internal control with MCCG 2017, there are still some strengths that LZNK has. Such strengths must always be practiced in the future as well as weaknesses and deficiencies being rectified.

LZNK was set up under the Kedah Darul Aman Zakat Board Enactment 2015 (ELZK, 2015) to carry out its core activities, namely administration of zakat collection and distribution of zakat to qualified *asnaf-asnaf* or qualified recipients of zakat in Kedah Darul Aman. Generally LZNK is renowned as a trustworthy entity for managing zakat affairs to the value of hundreds of millions of dollars. The teachings of Islam always remind each of its people to hold on to the trust and responsibility they bear. Allah S.W.T states:

"Verily, Allah has commanded you to surrender type of trust to its members (who are entitled to it), and when you execute the law among people, (Allah commands) you judge fairly. Allah is with (Command) it gives the best lesson to you. Allah is Hearer, Knower always looking"
(Surah An-Nisa ': verse 58)

With this great trust and responsibility, it is certain that strong corporate governance, risk management and internal control should be taken seriously by this institution. Although ELZK 2015 has been a guide to administration, management and all matters relating to LZNK governance, the need for codes and best practices of corporate governance is still evident to ensure that LZNK is on track. Corporate governance according to the Dictionary of the Fourth Edition means corporate governance as a means by which the actions or systems govern, manage and regulate a policy, function and travel of an organization or company that is accountable to the board of directors. Meanwhile, former Governor of Bank Negara Malaysia, Dr. Zeti Akhtar Aziz as quoted by Siti Zaleha, Amaludin and Zaid (2016) in their study defines best governance as encompassing participation, transparency and accountability that requires the involvement of all stakeholders. According to MCCG 2017 all corporate governance, risk management and internal controls are located with the board of directors. The Board of Directors has the power to monitor the whole entity in question even if they do not have executive power.

Recently we were shocked by the arrest of a zakat institution general manager in a state by the Malaysian Anti-Corruption Commission (MACC). This incident demonstrates the need for best practice in corporate governance, risk management and internal control in zakat institutions. The arrest of the general manager concerned by the MACC has given a negative

impression on zakat holders such as zakat payers, government and public in relation to the administration and management of large zakat funds.

Apart from managing large zakat funds, zakat institutions such as LZNK also face internal operations management such as payment of expenses, staff emoluments and business activities such as rentals. All of these activities require effective and efficient internal control or internal control. For external activities such as rental and asset development of LZNK, risk management is definitely an important aspect in carrying out this activity, for example, the risk of failure of the tenant to settle rental and related charges.

Enterprise Risk Management (ERM) is a feature of today's corporate world and was introduced by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 2004. ERM is a concept involving the board, the highest management and all risk management personnel for an organization. This concept is practiced by most companies listed on Bursa Malaysia while for international standards, the Geneva-Based International Organization for Standardization (2009) issued ISO 31000: Risk Management - Principles and Guideline which provides guidelines on risk management by an organization. This standard has been and is being used by companies in Malaysia and several government departments.

Finally, Siti Zaleha et al. (2016) in their study conclude that components of religious values and professionalism should be given priority in corporate governance as they are a constant reminder of the responsibility of Allah S.W.T and have positive effects in the task. As such, corporate governance, risk management and internal control can be implemented in accordance with established procedures and rules that indirectly contribute to the achievement of the zakat goals itself.

Previous Literature

Corporate Governance, Risk Management and Internal Control

Governance is an important element in determining the direction of an organization. For a profit-driven organization, corporate governance serves to safeguard the interests of stakeholders in the company, especially shareholders. Corporate governance is based on the assumption that there is a separation between the owner and manager of the company (Jensen & Meckling, 1976). Separation between owner and manager is difficult to identify if an organization is owned and managed by the same individual. To mitigate the problems caused by separation of ownership and management, effective governance should be practiced by the organization. Such mechanisms may consist of internal and external mechanisms of the organization.

Among the internal mechanisms that can be created are the establishment of a board of directors comprising capable members. Since the role of the board is wide enough, a subcommittee comprising the board of directors can be formed. Compared with the board of directors in charge of organizing policies and organizations, the role of this subcommittee would be to focus on specific matters relating to organizational travel. Among the committees to be established are committees for audit, rewards, tenders, risk management and nominations. In addition, other internal mechanisms that may be considered include the holding of a responsible internal audit to ensure that the organization has full internal control, compliance with relevant regulations and provide added value to the organization (DeZoort, Houston & Peters, 2001; Ahlawat & Lowe, 2004; Abbott, Parker & Peters, 2010). In addition, to ensure the relationship between the parties and the external parties including other stakeholders, the close ties between these parties must be continued through meetings and periodic discussions. With that in mind, a two-way communication process will occur and will reduce the knowledge gap between the two sides.

In terms of external mechanisms, the organization may appoint a qualified external auditor to monitor the financial position and performance of the company (Abbott, Parker, Peters & Raghunandan, 2003). Risk management is a process of identifying, evaluating and controlling risks. This process involves the use of organizational resources in an integrated manner so that the effects of the events that will be confronted are low or the organization can take advantage of the event. There are various risk factors and generally these risks are related to organizational characteristics. Among the risk examples are financial, image and operational risks. In facing or managing risks, there are several strategies that can be practiced by the organization. These strategies are to avoid, reduce, transfer, and accept risks. The selection of this strategy, among others, depends on the goals and management styles and the organization's environment.

Given that the risk management process is complex, the involvement and commitment of various parties is highly demanded. Apart from the board (Ishak & Mohamad Nor, 2017), the parties directly responsible for managing risk are the risk management committees, chief risk officers, and department managers or units. The involvement of the various parties will enable the awareness of risks to be appreciated and understood by all employees. This understanding helps those involved with risk management to plan and devise a more effective risk strategy. Risk management is closely related to the internal control of an organization or company. Effective internal controls can reduce the risk level faced by the organization or company. However, if internal control is loose and ineffective, the opposite will occur in terms of risk level.

The Legislation of the Kedah State Zakat Board (LZNK)

The Kedah Darul Aman Zakat Board Enactment 2015 (ELZK, 2015) is the main legislation adopted by LZNK and LZNK also set up under this enactment. ELZK 2015 is the state legislative level that has been enacted and gazetted as a guide for the entire zakat related activities in the state of Kedah Darul Aman. In addition, this enactment is also a guide for the LZNK itself as an organization entrusted with the exercise of zakat. ELZK is the 23rd Kedah State Law Enactment which was gazetted on 3 December 2015. It has seven divisions with fifty-three sections and two tables. The first part is the Beginning followed in the second part by the Establishment of LZNK Darul Aman while the third is the Authority and Function of the Board. The fourth part is the Relevant Allowance for Employees and Finance is the fifth section. Discipline And Surcharge are the sixth part and lastly, the seventh part is General Provisions.

This research found that almost all of the sections in ELZK 2015 are directly related to this research topic, such as governance, risk management and internal control. Governance is the layout and hierarchy in a company or organization as a whole (Ishak & Md Yusof, 2015; Turan & Koç, 2018). It determines and separates the functions and responsibilities of each hierarchy within the company or organization concerned. The board is the hierarchy or the highest component in governance and for LZNK as it is a corporation, it is referred to as a member of the board and is provided for and discussed in section 6 (1) ELZK 2015. The section details the required composition and number of board members comprising a chairman who is the secretary of the Kedah state government, a state legal advisor, a secretary who is also the chief executive officer of LZNK, a secretary of the Sultan of Kedah and not less than eight other members of which the majority of must have knowledge of the law, specifically law on zakat. Overall, section 6 (1) mandates that board members are proficient in the legislation and with this provision somewhat help to reinforce governance in LZNK.

Research method

Qualitative Approach

This research uses a qualitative approach to obtain the required research data. Researchers use semi-structured interview techniques with heads of internal audit division, deputy chief executive officer (Administration and Finance), head of finance department and head of LZNK quality management department. An interview session was conducted separately for each respondent. In addition, researchers also interviewed two academics who actively conduct research related to governance, risk management and internal control. Semi-structured interview techniques (semi-structured) are also used for these two respondents. The selection of responder-respondents in this research uses a purposive sampling technique. Through this technique, the researchers identified the respondents who were directly related to the research subjects (Sekaran, 2003).

The choice of the head of the audit division in LZNK as a respondent in this research is very important as the internal auditors' function and task is to audit and evaluate overall organizational governance, assessing risk management as well as internal control of an organization (MCCG, 2017). The position of an internal auditor is independent and is not directly governed by the direction of the chief executive officer (IIA Malaysia, 2017). He / she must report the result of the internal audit report to the board of directors or board member of the LZNK. The election of deputy chief executive officer (Administration and Finance) as respondents is very accurate with the title of this research as this position leads the administration and finance of LZNK as a whole. The functions and responsibilities of the deputy chief executive officer (Administration and Finance) involve managing governance, risk management and internal control in LZNK. This position is also entrusted to formulate and ensure efficient governance in LZNK as well as efficient of risk management and internal control.

For this research, the head of LZNK's financial department was chosen as one of the respondents. A finance officer is an obvious choice due to the roles and responsibilities entrusted to him. Assignments such as reporting accounts and financial statements of LZNK have become an essential task as a financial officer or accountant at LZNK but more importantly this ensures that internal controls practiced in LZNK work well. This is important to quality assure that accounts and financial reports are provided free of elements of offense and fraud. The head of the quality management department was also interviewed as this is the department responsible for the implementation of the LZNK Quality Management System (SPK) in order to obtain the MS ISO 9001: 2015 Certification.

Finally, two academics who actively conduct research related to governance, risk management and internal control were also interviewed. The selection of these two academics is important to receive feedback and views on governance, risk management and internal control. Their knowledge and experience can provide input to this research and further improve its quality.

Other Approaches

In addition to the qualitative approaches discussed above, this research also involves reviewing some important related documents. Annual financial reports, annual distribution reports and zakat collections were reviewed. Additionally, the Kedah State Zakat Board (Enactment 23) Enactment 2015 which became the primary law for LZNK was also referenced. Further, the financial procedures adopted by the LZNK were reviewed. Researchers also referred to MCCG 2017 which is applicable to the public-listed companies in Malaysia. Comparisons between MCCG 2017 and current practice by LZNK on corporate

governance, risk management and internal control were comprehensively carried out. All the documents used for this research were obtained through the LZNK website, the Securities Commission, the Malaysian Internal Audit Institute or directly through the LZNK staff.

Results and Discussions

Corporate Governance

Governance or corporate governance is synonymous with the corporate world but its terms and roles are also important to everyday organizations. Each organization needs a complete and clear layout in terms of rules, reporting lines and so on. This research examined the position of the audit department (IA) in LZNK and the scope of auditing.

"..... the internal audit in LZNK is an independent part entrusted to carry out auditing tasks at LZNK and zakat district offices The audit scope includes finance, ICT, performance or operations, follow-up and surprise check"

Source: Respondent 1.

The research also examined the extent of independence of the internal audit department and whether there are directives or interventions from the management including the CEO.

"..... the audit department has never received any directives nor intervention from the management including the CEO itself"

Source: Respondent 1.

From the above statement by respondent 1, it is clear that the internal audit division is completely independent without any intervention from management or CEO.

The research touched on LZNK organization charts and reporting lines in the LZNK organization.

"..... members of the zakat board or the board are the highest governing body in the LZNK followed by the audit committee and the next CEO"

Source: Respondent 1.

Respondent 1, the head of the audit division, stated that the audit report was sent to the CEO before it was tabled in the audit committee.

"..... the audit report ... we submit to the CEO first then table it in the audit committee"

Source: Respondents 1.

The statement from respondent 1 as mentioned above is somewhat different to the usual practice of internal audits in which audit reports are sent directly to the audit committee and copies are submitted to the CEO. Turning to the composition of zakat board members, deputy CEO (Administration & Finance) respondent 2 explained as follows:

"..... The CEO is a secretary to the board and the chairman of the board is the secretary of the Kedah state government also mention in act There are also two subcommittees in the board administration & finance committees and distribution committees these committee members are among the board"

Source: Respondent 2.

The existence of sub-committees in zakat board was proposed to two academics who were also respondents in this research. Both of them agreed that sub-committees in the board of zakat or any board of directors are very important as these sub-committees focus on the portfolio with which they are entrusted. Usually the composition of members in the subcommittee consists of board members who have certain expertise such as accounting and so on.

"... I think it's important that the subcommittee exists in the board because it focuses on certain portfolio and members have certain expertise such as accounting and so on"

Source: Respondent 5.

"..... the subcommittee is indeed in the board or zakat board ... because it has been good practice by corporate companies ..."

Source: Respondent 6.

Risk management

Risk management is an important aspect of governance itself. The success of a company or organization in governance also depends on the strength of the risk management that the company or organization has engaged in. For this research, risk management practices currently being applied by LZNK were examined.

"... emmm for risk management, LZNK management has set up a quality management department to carry out this matter this department is also required to implement the process of obtaining ISO 9001: 2015"

Source: Respondent 1.

"..... the quality management department was formed in 2018 to obtain ISO 9001: 2015 which is directly related to risk management this department was also entrusted by LZNK management to implement quality management system or SPK in LZNK. "

Source: Respondent 4.

Respondent 4 also explained the existence of a risk management master committee in LZNK. The holding committee was established in 2018 as a preliminary step towards risk management in LZNK. The head of quality management department acts as the coordinator of this committee. Three risk management sub-committees were also set up for three major departments in LZNK where they were led by each deputy CEO representing their respective departments. It is a risk management (administrative & financial) subcommittee, a risk management subcommittee (operations & distribution) and a risk management subcommittee (collection). The above explanation is explained by respondent 4 as follows:

"..... for the announcement of all.... last year 2018 has been assigned a committee the risk management master committee and three other risk management sub-committees in each of the major departments of LZNK led by each deputy CEO

Source: Respondent 4.

It is also understood that the risk management committee at the parent or small stage is yet to be fully mobilized because LZNK management needs to fully understand the implementation of risk management.

"..... emmm for the moment we have a new body of risk management committees at the master and small stages of the LZNK's main department ... and we are counting on our starting point for risk management at LZNK. "

Source: Respondent 2.

Regarding risk management in the finance department, respondent 3, labelled as the heads of financial department LZNK, explain that they are aware of the implementation of risk management at LZNK and ready for the implementation. The statement is as follows:

"..... yes we are in the financial department aware and take note of the implementation of risk management at LZNK the financial department gives full cooperation for the implementation of risk management"

Source: Respondent 3.

As for academics, they strongly recommend that zakat institutions such as LZNK do not miss the risk management aspect. This institution is entrusted to collect and distribute large amounts of funds or zakat. For the scope of this research, respondent 6, labelled as academics explain that the management of this large zakat budget requires risk assessment or focus on the risk aspects of management as in the following:

"..... zakat institution of this work it collect and distributes zakat so ... financial management with a large amount of money.... there is indeed a nature of concern of risk can not take easy financial chapter even if it's trust people money "

Source: Respondent 6.

Internal control

Internal control is another important aspect of an organization and in governance itself. Effective internal controls are capable of putting risk management into a high category thus establishing sound governance within a company or organization. In this research, it is once again emphasized that the scope of research has been limited to LZNK organizations including financial aspects and excluding aspects of zakat collection and distribution. Hence, internal control in this research has been focused on financial management by the finance department.

The interview session conducted with deputy CEO (Administration & Finance) as the person responsible for the administration and finance affairs of LZNK resulted in a number of research recommendations. First of all, he informed LZNK of a financial regulation formed in 2018.

"..... we have our own financial rules that were formed in 2018 so now we are using this for financial department"

Source: Respondent 2.

Respondent 3, head of the finance department, added that these financial regulations were originally from the Treasury Instrument documents (APs) and edited according to LZNK's suitability.

"..... actually the financial regulations come from the Treasury Directive we edit that suit LZNK so now this rule becomes the main regulation for financial affairs in LZNK"

Source: Respondent 3.

The head of the internal audit department, respondent 1 in this research, confirmed that LZNK already has a financial regulation established in 2018. Under the scope of the internal audit, it also covers the scope of financial audits and the financial regulations will apply for auditing 2019 onwards and Respondent 1 commented as follows:

"..... at LZNK there is already a self financing law established in 2018 our financial regulations will be used for auditing 2019 and so on"

Source: Respondent 1.

Conclusion and suggestion

Corporate Governance

Post the respondent interviews it was found that LZNK has a good governance foundation. Firstly, LZNK is guided by the Enactment 23 of the Kedah Darul Aman Zakat Board Enactment 2015 (ELZK, 2015). This Enactment becomes the main legal basis for LZNK. This Enactment provides in detail the establishment of board members, functions, powers and composition of board members. The provisions regarding the CEO including its functions are also described in this enactment as well as provisions regarding other employees in the LZNK. While ELZK 2015 also provides for LZNK's financial affairs. Therefore, ELZK 2015 is the basis of good governance to LZNK.

For internal auditing, researchers found that the audit processes and scope of the situation was in a good situation where it included financial, ICT, performance or operational audits, follow up audits and sudden checks. However the researchers understand the audit department staff is a team of just four people including the head of the internal audit department. Therefore, it is recommended that the number of internal audit staff be expanded to at least eight people. This is because the scope of auditing is quite extensive and includes auditing in district zakat offices throughout the state of Kedah. In addition, we recommend that internal audit staff, especially division heads, always attend accounting or auditing related workshops to keep them conversant with ongoing and current changes.

In the case of internal audit reports prepared by the audit department in LZNK, the report was first delivered to the CEO before being brought to the audit committee. Pursuant to auditing practices and as stated in MCCG 2017 and IIA, the audit report, whether comprising internal

or external audits should be submitted and presented directly to the audit committee comprising board members or directors. The CEO only receives a copy of the audit report and if there are any questions from the audit committee or board member regarding the audit report, they may call the CEO or the chief of internal auditors for clarification. It is recommended that LZNK be in line with the requirements as in MCCG 2017 and IIA and audit practices where audit reports should be submitted directly to the audit committee and not to the CEO. The audit committee is comprised of board members and responds to the board. This situation is efficacious because it is in line with governance practices and complies with the resolution of MCCG 2017.

The research findings also suggest that LZNK has its own governance code for this institution. LZNK refers to MCCG 2017 issued by the Securities Commission (SC) as the basis for the establishment of its own governance code in LZNK. Cooperation between LZNK and the SC can be mobilized to ensure the governance code introduced in accordance with LZNK as a zakat institution in Malaysia. This research further reinforces that LZNK as a professional zakat institution should have its own corporate governance code in line with the role that the institution has. Additionally, MCCG 2017 used in Malaysia today covers aspects of risk management, audit and internal control. These aspects are very important to corporate governance as a whole.

Risk management

Based on interviews with respondents from LZNK it was found that LZNK has begun an effort towards the formation of risk management at LZNK. Firstly, LZNK has set up a quality management department where this department is tasked with obtaining ISO 9001: 2015. This ISO 9001: 2015 is a standard that emphasizes risk management in an institution. Secondly, LZNK has established risk management master committees as well as risk management sub-committees under three deputy LZNK's CEOs. The three sub-committees are in the administration & finance division, the collection and da'wah division and the division of distribution & asnaf (qualified recipient) development. The formation of this risk committee is an early step in addressing risk management in LZNK. It is recommended that these risk committees be assessed to determine whether they are at the master level and if not, that the division move quickly to address this. LZNK may refer to the risk management practices by public listed companies in Malaysia, currently most popular are COSO ERM. The approach brought by this COSO ERM involves all the structures within an organization. It starts from board of directors and cascades to subordinate staff. Every stage in the organization has their respective role in risk management and thus a complete risk management approach.

Internal control

For internal control, LZNK already has financial regulations that were enacted in 2018. These financial regulations are modified from the Malaysian Treasury Directive in accordance with LZNK's compliance. The existence of such financial regulations was noted as a result of interviews with respondents. In this regard, the findings of this study are that LZNK always reviews and updates financial regulations in order to be in line with the rules that may be updated by the authorities or the government. This research reiterates that good internal control is able to reduce risk levels to an organization and ensure higher level governance.

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