

An Islamic Approach to the Theory of the Firm: The Views of Malaysian Managers

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Abstract

The conventional approach to the theory of the firm has not been adequate to respond to external, internal, and human dynamism. The market-based theory of the firm emphasises on the industrial organizational perspective only of the firm, which is lack of dynamism. The evolutionary approach into resource-based and knowledge-based of theory of the firm is also unable to provide a satisfactory theory of the firm due to lacks of spirituality foundation to sustain intellectual contribution from knowledge workers. Thus, this study explores an Islamic approach, which is based on *Tawhidic* paradigm to the theory of the firm as a mean to achieve organizational sustainable innovation and competitive advantage. The study obtained views through personal interview with 10 managers from companies that practice Islamic management system. The informants argued that the current practice emphasized on profit maximization and competitive advantage at the cost of human spirituality development.

Keywords: Theory of the firm, Islamic perspective, Malaysian managers

1. Introduction

The theory of the firm has been subscribed as comprehensive theory to describe the nature of the firm, the scope and boundaries of assessment on organizational environments, and the assessment of internal organizations to formulate, implement and evaluate organizational strategies. This theory cannot stand alone in the strategic management process due to its emphasis on the industrial organizational perspective only of the firm. The sustainability of the business, business continuity, and sustainable competitive advantage depends on both external and internal factors of the firm. The resource-based and knowledge-based of theory of the firm attempted to offer a dynamic and contemporary theory of the firm from evolutionary economics. However, the evolutionary economics view also is unable to provide the dynamic and contemporary theory of the firm. Indeed, a contemporary theory of the firm is necessary to provide insights for rigorous, dynamic and comprehensive strategic management analyses.

As an alternative, this study offers an Islamic approach to the theory of the firm the *Tawhidic* paradigm approach as a mean to achieve organizational sustainable innovation and competitive advantage. The knowledge-based view (KBV) offers an integrative framework to achieve sustainable knowledge management and organizational learning that are driven by knowledge-based view of firm innovation. The KBV view lacks of spirituality foundation to sustain intellectual contribution from knowledge workers. The *Tawhidic* approach contributes to the theoretical and practical understanding of the development of a unified theory of the firm.

2. Literature Review

Businesses continue to struggle to achieve sustainable competitive advantage for better profitability and strategic positioning in the competitive markets. The underpinned understanding in achieving sustainable competitive advantage is driven by organizational objectives. Garrouste & Saussier (2005) argued that organizational driven objectives are related to understanding of the theory of the firm. The theory of the firm that introduced by Coase (1937) rationalized by the theory of agency, theory of property rights and the theory of finance to develop a theory of the ownership structure of the firm (Aoki, 1986; Aghion & Tirole, 1997). In fact, the theory of the firm in Coase's seminal work had argued only on transaction cost, contract, nature of the firm, boundaries, and internal organizations (Coase, 1937, 1960, 1988). Coase (1937) and the scholars that follow his seminar work defined the firm as an economic entity that provides incentives and structure to solve organizational coordination (Hart, 1990; Holmström, 1999), the firm as a collection of assets, the firm as a collection of assets and incentive mechanisms, and the firm as a collection of capabilities of the past (Coase, 1937, 1960, 1988).

The firms were formalized to avoid inefficiency in terms of moral hazard by internally organized through authority and hierarchy, assets ownership and hierarchy, and communication in hierarchy. By integrating and formalizing the problems in the agency, property rights, and ownership structure (Aoki, 1986; Aghion & Tirole, 1997). The firms are still unable to cope with internal and external organizational choices (Garrouste & Saussier, 2005). The trade-offs and assumptions of operationalizing the firm are still between risk and uncertainty, which is lacking of the role of the market players and entrepreneurs. Thus, there is insufficient element to have a unified theory of the firm. The theory of the firm based on Coase (1937) has serious flaws, namely (a) unable to clearly define the nature and the boundaries of the firms because some transactions are internalized while others are externalized, and yet others are both internalized and externalized; (b) internal

structure of the firm was not clearly and formally organized in terms of the production, incentives, controls and internal hierarchies; and (c) the relations between the firms and the market are not clearly defined whether firms are substitutes for the market or firms are not the market but players of the market with some limitations (Garrouste & Saussier, 2005).

The theory of the firm by Coase (1937) that being subscribed by the economists and business educationists are not unified theory due to its bounded rationality approach that made roles of entrepreneurs become uncertain (Kay, 1992). In addition, the role of institutional environment that affect the firm's decision is also unclear and vague. In fact, Coase's theory of the firm is very simplistic in which it assumed that the existence of the firm is due to the existence of transaction costs, and the firm's boundaries are defined by a simple calculus of transaction costs that are related to the Property Rights Theory and the Incentive Theory.

In short, Coase's theory of the firm and its formalized theories are unable to offer a comprehensive, dynamic and contemporary theory of the firm due to lack learning processes both at the individual and organizational levels. Thus, the alternative theory of the firm that based on evolutionary theory and resource-based view of the firm can fill in the gap of learning and capacity building in the firm (Nelson & Winter, 1982; Kogut & Zander, 1996; Langlois & Garrouste, 1997). These two views have a common assumption, namely the behavioral assumptions (learning and rule-guided behavior) and assumed that knowledge and capabilities represent the firm's critical and distinctive resources (Foss, 1996; Poppo & Zenger, 1999). They argued that the resource-based and knowledge-based views of theory of the firm are more unified and comprehensive due to three arguments, namely knowledge is generated as the result of learning and experience; the result of learning, it is context (local) and path-dependent (historical), and it is partly tacit, and the organization is partly unaware of its existence because it is embedded in organizational routines and individual skills (Garrouste & Saussier, 2005).

2.1 The way forward for a contemporary theory of the firm

The resource-based and knowledge-based theory of the firm attempted to offer a contemporary theory of the firm based on the evolutionary perspectives. However, given the background of the contemporary business world that is full with uncertainty due to the globalization process, rapid changes are rampant due to the fast paced of technological development, high mobility of society, and high intensity in competition (Mahutga & Smith, 2011; Vergragt, 2012). This situation makes the business world competitive due to the increasing of enterprises that are competing on the uniqueness (Liu, Chen, & Tsai, 2004).

The evolutionary perspectives emphasized on the importance of knowledge and innovation in facing the still competition to achieve sustainable competitive advantage (Karim & Hussein, 2008), but the firms are not able to do so with the increasing moral hazard events that hampered firms to create and sustain competitive advantage. There is increasing need to go back to the root of intellectual development, which lies in the soul of human. Lewis (2006) argues that the current business world can gain and sustain its competitive advantage when it is imbued with the soul (spirituality). Osman-Gani and Sarif (2011) argued that the excellence in spirituality leads to better worldview, far sighted and continuous improvement that guided by commendable values.

Based on the flaws in the attempt to offer a comprehensive theory of the firm, this study postulates an insight from Islamic perspective that a contemporary theory of the firm can be developed to gain and sustain competitive advantage via *Tawhidic*-based theory of the firm. *Tawhidic*-based theory of the firm is based on Islamic monotheism worldview that the dynamism is actually part of the process to attain ultimate victory in this worldly and the hereafter life.

Given the dynamic contents of the business world, managers need comprehensive and rigorous theory of the firm to make the business continues to make profit on sustainable basis. The production-based economy provides the competencies to maximize profit through cost minimization and resources optimization. Resources in today's world are not only physical and organizational resources, but also human potentials that are transformed into competencies and capacity building.

Realizing the need for human potential in the business and economy, business strategists are gradually subscribing knowledge-based economy that are capable of responding to fast paced globalization. In other words, organizations must be able to advance their technology and competencies so that they can cope with the knowledge-intensive business services, very fast acceleration of product cycles, and changes of customers' tastes and preferences. In facing the competitors, knowledge about the industry, market and customers is essential.

Organizations must always acquire knowledge and continuously learn from various stakeholders to gain competitive advantages. The knowledge intensive business requires the unique competencies to be innovative. Innovation capability is not with the organizations, but with the individual knowledge workers and who possess knowledge and other intellectual derivatives. The classical innovation works on linear basis, less interactive and within the formal organizational network. Unlike the contemporary innovation, it works on dynamic mode, highly interactive and hybrid organizational network.

2.2 Tawhidic Paradigm

This section elaborates on the *Tawhidic* paradigm perspectives. Mohd Kamal Hassan (2010, p.187) explains that *Tawhidic* paradigm is about Islamic monotheism thinking to serve as the true servant of Allah (*'ibād al-Rahmān*), vicegerents (*khulafā' fī al-ard*), true believers (*al-mu'minūn*) for the sake of betterment of mankind (*khayra ummatin ukhrijat lil-Nās*) (Qur'ān, 3:110) and 'balanced community' (*ummatan wasatan li-takūnū shuhadā' alā al-nās*) (Qur'ān, 2:143).

According to Al-Faruqi (1992, p.5), the subscription to *Tawhidic* paradigm manifests the readiness and willingness to fulfill the Divine trust (*al amānah*) and obligatory duties (*al farā'id*) that are accompanied by the Divine guidance and human unique capability (Qur'ān, Surah Hud, 11: 6 and Sura Az Zumar 39: 41).

The integration of Tawhidic paradigm with the theory of the firm enhances the understanding on the theory of the firm. According to Zarkasyi (2010), unification of knowledge is the basis for unity in wisdom and action. Based on Al-Ghazālī's approach of organizational and human wisdom and soul development, knowledge can be divided into religious and rational knowledge. Religious knowledge includes the science of the practical religion (*'ilm al-mu'amālah*), God's guided knowledge on how the religion can be executed (*'ilm al-shar'iy*), and knowledge that derived from human intellect (*'ilm al-'aqliyy*). The scope of the practical religion (*'ilm al-mu'amālah*) is available in two forms, exoteric (*zāhir*) and esoteric (*bātin*) sciences. The exoteric (*zāhir*) sciences include the act of worship (*'ibādat*), social ethics (*'ādat*), and matters pertaining to dangerous act (*muhlikāt*). As for esoteric (*bātin*) sciences, it is about spirituality dimension. The second category of knowledge is the rational knowledge (*'ulūm al-'aqliyyah/ 'ulūm ghayr shar'iyah*). This type of knowledge can be divided into fundamental (*usūl*) and subsidiary (*furū'*). The fundamental knowledge includes mathematics/logic, natural science (observation and experiment), and investigation science of existence. The theoretical classification of knowledge allows organizations to identify priorities, resources, and efforts to convert the knowledge into absorptive capability. Zarkasyi (2010, pp.162-164) argued that there are two ways knowledge can be acquired by individuals, namely through human teaching (*al-ta'lim al insaniyy*) and Divine teaching (*al-ta'lim al rabbāniyy*). People learn from other people via face-to-face and other instructional ways (Zabeda, 2004, 2008) with monetary or non-monetary rewards (Zabeda, 2008). However, the Divine teaching is highly spiritual when the learners acquiring knowledge based on Divine revelation (*al-wahy*), inspiration (*ilhām*), reflection and contemplation (*al-ishtighal bi al-tafakkur*). The absorptive capacity to acquire human and Divine teaching is through five capabilities (power), namely common sense (*al-hiss al-mushtarak*), representative power (*al-quwwah al-khayāliyyah*), estimate power (*al-quwwah al-wahmiyyah*), retentive power (*al-quwwah al-hāfidah wa al-dhakirah*), imaginative power (*al-quwwah al-mutakhayyilah/ al-quwwah al mutafakirrah*).

2.3 Tawhidic Paradigm (TP) and the Theory of the Firm (TOF)

This section elaborates *Tawhidic* paradigm can be integrated with the theory of the firm upon the foundation of Islamic faith. The Islamic faith is based on *kalima shahaada*, which is to recognise Allah as the only universal God and Prophet Muhammad (Peace Be Upon Him) as the messenger of Allah. With this foundation, the ultimate aim of Islamic management system is to gain the pleasure of Allah by executing all of the duties prescribed by Him. The discussion of this paper begins with the explanation on the major components of *Tawhidic* paradigm. According to *Tawhidic* paradigm, man's multiple relationships revolve around *Tawhid*. In fact, there are prerequisites to *Tawhid* and the roles of the believers of the paradigm.

2.4 Integrating the Theory of the Firm and the Management of the Firms

This section elaborates the nature of the firm from organizational perspectives. The development of a unified theory of the firm requires a comprehensive assessment on internal, external, explicit and implicit aspects of the firms (Garrouste & Saussier, 2005; Debowski, 2006). Debowski (2006) contended that contemporary theory of the firm for knowledge management development includes the organizational process and support. The integration of the theory of the firm into the five phases of knowledge development of the firm include knowledge sourcing, knowledge abstraction, knowledge conversion, knowledge diffusion and knowledge

refinement. Knowledge sourcing involves organizational task to identify relevant information from the market and feedback from stakeholders. Knowledge abstraction is about making sense of the information obtained from the market into theories and assumptions. The next step will be knowledge conversion, to codify tacit and embodied knowledge into explicit and codified knowledge. The codified knowledge is transferred, transmitted and diffuse for greater use.

A unified theory of the firm is an essential understanding to mobilise economic scarce resources and transform them into goods and services to benefit mankind. Gibbons (2005) argued that firm is basically a vehicle for entrepreneur to mobilise resources to create wealth sustainably. Previously, Williamson (1971, 1979, 1985) argued that firm is used to generate continuous income for the owners of the firm; he called this activity as 'rent-seeking' behavior of the firm. Similar observations are made by Klein (1988, 1996). Firm is also being used as formal vehicle to own resources or 'property-rights' so that it can continue to be the beneficiary of the resources (Hart & Moore, 1990, and Hart, 1995). Other scholars argued that firm provides 'incentives' to economic system to generate wealth (Holmstrom, 1982, 1999). Cyert and March (1992) argued that firm sets the foundation for organisation to create goals, provide expectations and choices. Goals are very important for members of organisation to make commitment and shape the required behavior in order to achieve desired outcomes. Expectations are related to the potential benefits or advantages in the future that can be envisaged so that people can adjust the present behaviour in order to fulfil the future target. The firms make choices or solve problems based on goals and expectations so that the choices maximize the potential goals (Cyert & March, 1992; Cyert, Dill & March, 1958).

Firms could attain objectives and goals if they are managed efficiently and effectively. Management can be defined as the process of working with and through people via planning (P), organizing (O), leading (L), and controlling (C) - P-O-L-C - the people and other resources to achieve the objectives or goals (Daft, 2010; Dyck & Neubert, 2009). This definition is based on the classical theory of scientific management (Dyck & Neubert, 2009). In other words, there are four functions involved when managing firms or any organizations, i.e. to determine the goals, to arrange the task and structure, to work with other people collectively, and to ensure results are achieved (Daft, 2010; Dyck & Neubert, 2009).

Daft (2010) argued that managers apply management functions of planning, organizing, leading and controlling to achieve goals of their organization. Planning is defined as the process to formulate goals for future performance together with the resources required. Organizing refers to the arrangement of tasks, responsibilities, accountability, and resources allocation to enable the organization to execute activities that attaining the goals. Leading is about the use of influence on employees so that they are motivated, willing and ready to perform the tasks assigned to them. As for controlling, it is about monitoring employees and resources so that they are on the right track to achieve the goals of the organization.

Thus, the study hypothesizes that

- (a) The existing theory of the firm with a unified or without has serious flaw theoretically and practically for business decision makers to address the challenges of the contemporary nature of business activity to sustain competitive advantage; and
- (b). There is no comprehensive and contemporary theory of the firm from *Tawhidic* paradigm in which the understanding of *Tawhidic* paradigm influences business strategists to formulate firm strategies to be more comprehensive, rigorous and dynamic.

3. Methodology

The objective of the study is to explore for a contemporary theory of the firm from an Islamic approach, which is based on *Tawhidic* paradigm. The nature of the study is not to test the existing theory of the firm, but to develop from the ground (field) a contemporary theory of the firm based on *Tawhidic* paradigm approach. The study used qualitative method via personal interview with 10 managers from the companies that practice management system from Islamic perspective in Malaysia. The use qualitative method in this study to obtain detailed explanation from the informants regarding the nature, factors, incentives, boundaries, details of business activities in Malaysia that leading to offer a contemporary theory of the firm based on Malaysian context.

The use of qualitative method through personal interviews is appropriate for exploratory nature of studies. Miles and Huberman (1994) argued that qualitative method is appropriate to examine complex and difficult contexts of study because they can put the situation/s in question into the right perspective. In addition, Marshall and Rossman (1989) recommended the use of qualitative methods to enable researchers to ask more questions in order to explore the context of the study in greater detail. The nature of business activity is dynamic because it

involves different perspectives and understanding of different individuals. Such situations are best understood utilising qualitative method (Ezzy, 2002; Lee, 1999). Further, qualitative method also enables the researcher to identify and understand the complex relationships in knowledge transfer between firms (Lee, 1999; Rist, 1994). By asking questions in personal interviews, the researcher will get varieties of answers that are relevant to the interview questions (Patton, 2002; Silverman, 1993). There are many techniques to obtain data using qualitative method, such as active or passive participation and observation, personal interviews, content analysis on various documents, and case study (Patton, 2002; Lee, 1999; Creswell, 1998). The study obtained views through personal interview with 10 managers from companies of various business activities that practice Islamic management system.

4. Findings and Discussion

This part presents the feedback from the personal interview with 10 managers on the practice of Islam on the theory of the firm at their organizations. Table 1 summarizes the profile of the informants. The informants were asked questions pertaining to the practice of Islam in managing their firms.

Table 1: Informants' Brief Profile

Code	Position	Principal activity	Location of business
TF1	Senior manager	Entertainment	Petaling Jaya
TF2	Managing Director	Food	Johor Bahru
TF3	General Manager	Plantation	Kuala Selangor
TF4	Branch Manager	Construction	Petaling Jaya
TF5	Manager	Corporate banking	Shah Alam
TF6	Senior General Manager	Agriculture	Sungai Buluh
TF7	Vice President	Food	Shah Alam
TF8	Senior Manager	Construction	Rawang
TF9	Managing Director	Landscape	Shah Alam
TF10	General Manager	Tourism	Kuala Lumpur

TF 1 argued that the company decided to subscribe quality standard on management system from Islamic perspective as a part of the effort for good corporate governance. TF 1 said:

My company decided to get Islamic management certification after obtaining information about the quality system or ISO from Islamic perspective by the Standards Department of Malaysia. That's really awesome when Malaysia produces its own ISO system based on Islamic philosophy. The most interesting part, the ISO is not meant for Muslims only, but also for any company who is interested to get ISO certification based on Islamic system. All this while, the non-Muslims though being certified with Islamic system is automatically converted to be Muslims.

TF 2 contended that the practice of Islam on the management of the company has been part of the business creed due to the religious background of the founders. TF 2 uttered:

Our founders are very religious and committed professional Muslims. They wanted the business to be devoted to Islamic teachings. They keep reminding us, all the managers and workers, the quality of work in this company should be equivalent to the obligatory prayers that we perform five times a day. The reason for this is that both working and performing prayers are regarded as worshipping Allah. If one steadfast and committed in worshipping Allah, one will produce best quality of work. The logic is simple – to enter into the paradise of Allah, one must be of the highest quality.

TF 3 decided to use Islamic management system because the company believes that it can contribute to the human wellbeing. TF 3 pointed out:

Doing business is about making a value in the interactions with and through people. Our customers are human being who wanted to satisfy their mind, soul and physical. Similarly, our employees, suppliers, partners, and the stakeholders are also wanted to have more values in the transactions. People have been talking about good relationships with the stakeholders yield long term revenue and customer loyalty. Not to pretend or making false impressions to customers just to lure them. If we treated customers as objects, we have denied their basic human rights to be respected.

TF 4 emphasised that the company has been complying with many construction management standards as a mean to gain confidence from the public. TF 5 argued that the company practices Islamic management standard due to its nature in Islamic banking and finance. TF 6 argued that the Islamic practice in managing the company can increase productivity and company's financial performance. Moreover, TF 6 believed that the soul aspect of human also needs nourishment.

TF 7 pointed out that efficiency and effectiveness are very important in managing of a company and the practice of Islam reinforces human soul to devote in the process to achieve goals of a company as well as personal goal in the form of worship to Allah. TF 7 said:

Today, we can see many corporate managers practice Islamic code of conduct even though some of them are not Muslims. They impressed with the attitude and manners shown by Muslim corporate leaders. Even now we can see a CEO of a big company becomes chairman of mosque. He used his corporate experience in making the mosque very active in organizing spiritual and professional events.

TF 8 argued that the practice of Islamic management approach is not about influencing or an attempt to convert non-Muslim to become Muslim. TF 8 emphasised that the Islamic management approach promotes universal values in managing people and organizations.

TF 9 contended that the tragedy of 911 in the United States of America has attracted many people to understand Islam and appreciate the good universal values preach in Islam. TF 9 articulated:

Most of my business partners and associates are non-Muslims and I have been in this landscape business for more than 20 years. In the past, they were not interested to talk about Islam in business dealings. But, now they are very interested to know about Islam not only in business, but also in political, social, and in all human activities. They even wanted to get the Islamic Quality System by SIRIM, halal and toyyiban certifications and so on.

TF 10 argued that the practice of Islam in managing a business is not about having a label of Islam. It should be beyond merely compliance. TF 10 said:

In tourism business, people always thought about halal food, no gambling, no prostitution, and everything must be free from vices. In my opinion, tourism and hospitality are about giving services to customers on how they can spend their vacation and to appreciate the time they spent with friends and family members. When I brought my customers to see the nature of wildlife, the rain forest, the waterfalls, live in the forest, they became appreciative to the nature and some of them joined clubs or associations that advocating the protection of the rain forest and the wild life. This is really win-win situation. I got my business continues, and my customers obtained very good lessons about being friendly and ethical to the natural environment.

Based on the informants' feedback, the practice of Islam in the companies reinforces the mind, soul and body of people in the companies to be reflective on human values, corporate governance, efficiency, and effectiveness. Table 2 summarizes the informants' feedback into several key values, namely good corporate governance, good human wellbeing, and company's effectiveness and efficiency.

Table 2: Summary of Informants' Feedback

Code	Main points	Key values
TF1	subscribe quality standard on management system from Islamic	Good corporate governance

	perspective as a part of the effort for good corporate governance	
TF2	practice of Islam on the management of the company has been part of the business creed due to the religious background of the founders	Human and society well being
TF3	contribute to the human wellbeing	Human well being
TF4	complying with many construction management standards	Good corporate governance
TF5	increase productivity and company's financial performance	Company's effectiveness and efficiency
TF6	soul aspect of human	Human well being
TF7	reinforces human soul to devote in the process to achieve goals of a company	Human well being
TF8	promotes universal values in managing people and organizations	Human well being
TF9	to understand Islam and appreciate the good universal values	Good corporate governance
TF10	beyond merely compliance	Good corporate governance

In other words, the integration of Islam into the theory of the firm reinforces good human and organization governance for the sake of producing benefits to individual human, organizations, and the society. The informants argued that the current practice emphasized on profit maximization and competitive advantage at the cost of human spirituality development. The Islamic approach to theory of the firm includes a comprehensive view on the organizational driven objectives (Garrouste & Saussier, 2005). The typical indicators of theory of the firm on the transactional aspect, contracts, boundaries, and relationships with the stakeholders (Aghion & Tirole, 1997) are inadequate to cope with internal and external organizational choices (Garrouste & Saussier, 2005). The role of the stakeholders is essential to fill in the gap of learning and capacity building in the firm (Nelson & Winter, 1982; Kogut & Zander, 1996; Langlois & Garrouste, 1997) with several themes namely, good corporate governance, good human wellbeing, and company's effectiveness and efficiency.

5. Conclusion

The study aims to provide an Islamic approach to the theory of the firm so that a comprehensive understanding and practice of the theory of the firm enables companies to be responsive to the external, internal, and human dynamism. The flaws in the market-based theory of the firm were due to the emphasis on the lack of dynamism and human governance on that solely based on industrial organizational perspective only on the firm. Although the conventional approach uses the evolutionary approach into resource-based and knowledge-based of theory of the firm, but they are unable to provide a satisfactory theory of the firm due to lacks of spirituality foundation to sustain intellectual contribution from knowledge workers. Thus, the contribution of an Islamic approach based on *Tawhidic* paradigm to the theory of the firm enables companies to achieve organizational sustainable innovation and competitive advantage. Thus, the feedback from the 10 informants has confirmed that (a) the existing theory of the firm with Islamic approach has reduced the serious flaw theoretically and practically for business decision makers to address the challenges of the contemporary nature of business activity to sustain competitive advantage; and (b) the presence of Islamic approach provides a comprehensive and contemporary theory of the firm from *Tawhidic* paradigm in which the understanding of *Tawhidic* paradigm influences business strategists to formulate firm strategies to be more comprehensive, rigorous and dynamic. However, the results of the study can be more rigorous and comprehensive when the study includes more informants that represent the stakeholders of the economy.

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