Islamic Perspective of Corporate Governance

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Abstract:

This paper reports the features of corporate governance in Islamic values and explains the existence of principles of good corporate governance in Islam. The article takes a theoretical approach, and reviews the existing literature on Islamic corporate governance. The paper explains the differences between Islamic and the traditional corporate governance. The paper shows that Islamic corporate governance is driven by faith-based rationalism and the social welfare criterion. Also, Islamic governance requires relatively stronger mechanisms.

The paper concludes that Islamic law improves the corporate governance practice by improving the process of accountability,

transparency and disclosure, responsibility fairness, protects the rights of stakeholders. Therefore, Islamic corporate governance requires company directors to perform their duties within responsibility and satisfying the needs of the stakeholders and Allah. Hence, educational system in Islamic world should be a holistic educational system.

Key wards corporate governance, Islam, accountability, responsibility, corporation, transparency and disclosure.

1- Introduction:

Prior to 1997, the research carried out on corporate governance around the world was minimal (Shleifer and Vishny, 1997; O'Sullivan, 2000). However, the crisis that swept the financial markets and economies of the major Asian countries in 1997 and the failure of several famous names (e.g. Enron, WorldCom and Parmalat) that have occurred in the last 20 years led to questions over the importance and significance of good corporate governance practices. Therefore, interest in corporate governance has grown and attracted considerable attention in the area of academic research and public policy in both developed and less-developed countries (Mallin, 2004; Solomon and Solomon, 2004; Sternberg, 2004). Corporate governance has also changed markedly to be an essential feature of companies (Hussain and Mallin, 2002), and a key to developing a market economy and civil society in transitional economies (McCarthy and Puffer, 2003), where investors are uncertain about the protection of their property rights. For instance, a survey of international investors by McKinsey & Co in 2002 found that 85% consider corporate governance in Africa and Eastern Europe to be "equally, or more, important than financial issues in deciding which companies to invest in"(Nganga et al, 2003). Hafeez, (2013) concluded the main features of corporate governance as: ensuring that an adequate and appropriate system of control operates within a company; preventing any single individual from wielding too much an influence; concerning the relationship between company management, board of directors, shareholders and other stakeholders; making sure that the company is managed in the best interest of shareholders and other stake holders and encourages both transparency and accountability. Developed countries are therefore now paying attention to corporate governance in order to avoid economic problems, and numerous studies have been done in these countries to develop their corporate governance. In developing countries - where most of Islamic countries are based - minimal research has been done and there is still a lacuna in the literature on corporate governance development (Okike, 2007; Tsamenyi et al, 2007).

The main objectives of this study are to briefly portray the models of corporate governance and present the Islamic corporate governance to explore its features comparing with non-Islamic model. Hence, the study takes a theoretic approach, and reviews the existing literature on corporate governance and Islamic values to explore and analyse how much corporate governance principles are presented in Islam. Literature shows that researches of corporate governance in Islamic views have focused on the analyses of similarities and differences with the international practices and minimal researches has focused on how much corporate governance existence in Islam. Therefore, this study is to fill the gap in the literature that related to corporate governance Islamic perspective.

2- Definition of corporate governance:

There is no real consensus on the definitions of corporate governance (Keasey et al, 1997; Solomon and Solomon, 2004). Solomon and Solomon (2004) argued that there are substantial differences in the definitions of corporate governance according to which country is considered, and the viewpoint of the policy maker, practitioner, researcher or theorist. More precisely, the core of corporate governance depends on who controls the corporation and the extent of separation of ownership from control is the crucial issue (Shleifer and Vishny, 1997). In the same perspective, the term of corporate governance is related to the term corporation, so to understand corporate governance we need to know what does corporation mean. Monks and Minow (2004; p 9) define a corporation as:

> "A mechanism established to allow different parties to contribute capital, expertise and labour for the maximum benefit of all of them. The investor gets the chance to participate in the profits of the enterprise without taking responsibility for the operations. The management gets the chance to run the company without taking the responsibility of personally providing the funds."

There is a broad consensus that the underlying problem of corporate governance is related to the company's growth and through the separation of management and ownership (Keasey et al, 1997; Solomon and Solomon, 2004; Mallin, 2004). This separation might lead to conflicts of interests between owners, whose interest is to maximise their profit, and the management, which usually focuses on finding a balance between the shareholders' interest and maintaining the corporation especially, in the long-term. Therefore, corporate governance systems differ between countries, reflecting contrasts of legal systems, cultural systems and economic environments.

In this way, corporate governance models in non-Islamic economy is divided into two models: Anglo-American Model (Unitary System) and the German Model (Dual System). In the Unitary system the “Corporation” concept is based on a fiduciary relationship between shareholders and management. Based on the concept of market capitalism, the Anglo-Saxon system is founded on the notion that self-interest and decentralised markets can function in a self-regulating, balanced manner (Cernat, 2004). The model assumes the dispersal of ownership across a large number of individual and institutional investors (Keasey et al, 1997; Solomon and Solomon, 2004). The Unitary System model is also characterised by the recognised primacy of shareholder interests and the protection of minority investors and strong requirements for disclosure. Hence, the concept of corporate governance focuses on the relationships between the corporation and its shareholders, and refers to a company’s relationship with its shareholders to ensure that it acts in accordance with their interests. Keasey et al (1997: p4) stated that corporate governance may be described as “a form of accountability of senior management to the shareholders’’.

The second model is the German Model (Dual System), where, the accountability and responsibility of the corporation is not just to the shareholders, but goes beyond them to other stakeholders. The corporation is responsible to the wider society and should be resolving the conflict of interest between the related groups. This corporate governance model has been characterised by a pyramidal ownership structure, with companies owning each other through a series of cross-shareholding, extensive bank proxy voting and family ownership (Solomon and Solomon, 2004).

Therefore, corporate governance in western perspectives requires company directors to perform their duties with mainly satisfying the needs of shareholders and other stakeholders byfinding a balance between the shareholders' interest and maintaining the corporation in the long-term.

3- OECD principles of Corporate Governance

The OECD (Organisation for Economic Co-operation and Development) established Principles in 2004 to assist OECD and non-OECD members in their efforts to improve corporate governance practices.).The OECD defined corporate governance in its Principles of Corporate Governance (2004) as:

"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined".

Nowadays, the OECD principles of corporate governance serve as a basis in the sphere of international corporate governance having become a specific benchmark for corporate governance issues and being used by other organisations, such as the World Bank. The OECD principles of corporate governance covered the following areas;

1- The Rights of Shareholders and key ownership functions through protecting and facilitating the exercise of shareholders' rights.

2- The equitable treatment of shareholders by ensuring the equitable treatment of all shareholders, including minority and foreign shareholders.
3- The role of stakeholders in corporate governance through recognising the rights of stakeholders that established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
4- Disclosure and Transparency by ensuring that timely and accurate disclosure is made on all material matters regarding the corporation.
5- The responsibilities of the board by ensuring the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

4- Business in Islam and the corporate governance principles

In respect of the Islamic economy, the Islamic financial system was developed in the Islamic world during the middle ages; however the last four decades have witnessed its rise insignificance in the global economy. This revival is attributed mainly to the following reasons:

1- The boost in the oil-related income following price increases during the 1970s of many Muslim Arab countries.

2- The desire of Muslim populations is to develop financial products and financial services that are compatible with their religious beliefs.

3- Dissatisfaction of some Muslims with the materialist ideologies of capitalism and with communism and the uneven performance of western financial markets (Grais and Pellegrini, 2006).

The main rule in business activity in Islam is honesty and fair dealing, so the Muslim business person should have moral values, and the market should be free. The Islamic economic system allows people to earn their living in a fair without exploitation, and emphasises the welfare of the society over individual rights (Lewis, 2001). In a similar manner, Islam prohibits transactions involving uncertainties, such as speculative investments. Therefore, people engaging in business should behave equitably, and should not lie about weights and measures. That is because the Holy Qur'an stated in Surat Al- Mutaffifin(verse1):

"Woe to Al-Mutaffin (those who give less in measure and weight)".

Also, in Surah Ar-Rahman Verse 9 "And observe the weight with equity and do not make the balance deficient."

Corporation in Islam is defined as

"a legal entity where the principle and proportionate of the firm's shares owned by the shareholders based on equity participation and profit sharing ratios and deals with legal and organisational structures that control the internal governance of a firm with an objective to define and attain an objective criterion by way of understanding the relations between variables supported by policies, programs and strategic coalition" (Choudury and Hoque, 2006).

In order to conform to Islamic rules and norms, financing in Islam depends on the prohibition of receipt or payment of interest. Instead, financing is done through progressive Islamic transformation by co-operative instruments such as Mudarabah and Musharakah (Choudhury and Hoque, 2006). According to Lewis (2001):

- Mudarabah partnership is formed whereby management is stipulated for one of the partners and other partner(s) are investors.

- Musharakah partnership is formed whereby management and participation is stipulated for all partners, whether or not all partners participate.

Furthermore, there are two other principal categories of business in Islam:

- Hire is based on the capital hiring labour for a job and then fixing wages. In this case, the financier will receive all profits and at the same time is responsible for all losses.

- Modern companies where investment can be made through the stock market but this trade has to involve halal commodities only.

Islamic values require company management and board of directors to perform their duties with satisfying the needs of the shareholders, other stakeholders and Allah. Therefore, corporate governance in Islam aims to enhance accountability, transparency, responsibility and fairness where these values are paramount and introduced in Islam as follows:

1- Accountability: Muslims believe that they will be made accountable for whatever they do (i.e. both bad and good actions). The word of accountability is repeated in the Holy Qur'an in different verses. For instance, Surah Al-Baqarah verse 284 says:

" To Allah belongs all that is in the heavens and all that is on the earth, and whether you disclose what is in your ownselves or conceal it, Allah will call you to account for it".

Surah Ibrahim verse 51 "That Allah may require each person according to what he has earned. Truly, Allah is swift at reckoning".

The generic sense of accountability in Islam is accountability to God (Allah) and to society for all activities that a Muslim has to carry out. Consequently, each individual is under a "self-monitoring duty" that is an obligation to supervise adherence to his terms of reference and accountability to God and himself. Also in Islam where economic, political, religious and social affairs fall under the Islamic law (the Shari'ah), accountability refers to a legal system in keeping with the code of behaviour called for by the Holy Qur'an and the Hadith[1] (Lewis, 2006).

Islam takes an extremely serious stance on accountability, not just for the present but for the future life, and asks followers to respect public property. Therefore, corruption, and other unacceptable behaviour, has been prohibited by Islamic values. For instance, in Sura Albaqra Verse188, it states: “Do not eat up one another’s property unjustly nor bribe with it the judges in order that you may knowingly and wrongfully deprive others of their possessions”.

Moreover, the Prophet Mohammed (PBUH) once said:

[1] Saying of the Prophet Mohamed (PBUH)

"If someone among you sees wrong he must right it by his hand if he can (deed, conduct, action). If he cannot, then by his tongue (speak up, verbally oppose); if he cannot, then by his gaze (silent expression of disapproval); and if he cannot, then in his heart. The last is the minimum expression of his conviction (faith, courage)" (Er, 2008).

Therefore, the accountability in Islam is a dual accountability, accountability to God and human being (Kasim et al., 2013).

2-Transparency and disclosure: Islam also requires an obligation of good faith in contracts and dealings. This requires taking positive steps to do the right thing, making full and honest disclosures and performing his obligations correctly. In this way, Allah has encouraged in the following verses (*ayat)* transparency:

" O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justices between you". (Al-Baqarah: 282)

"... and knows what you conceal and what you reveal" (Surah An-Naml:25)

Islamic values emphases on produces true and fair disclosure of financial facts and accurate information to community to pay of accurate Zakat[2].

3- Responsibility: the concept of trustworthiness is stated in Surah Al-Anfal (verse 27):

[2]Zakat is a social obligation to pay wealth and resource tax on retained earnings which is given to the poor and the needy. It is equal to 2.5 per cent of idle wealth and assets annually.

“O you who believe! Betray not Allah and his Messenger, nor betray knowingly your Amanat (things entrusted to you and all the duties which Allah has ordained for you)”

It is a highly regarded virtue in Islam that every individual within an organisation is required to subscribe to standards of ethical conduct while carrying out their commercial activities. Islam prescribes a system of Zakat, and encourages its believers to give money to the poor only to purify himself, not in return for any favour done to him when in SuraAlail verse 17-21states that:

“He who spends his wealth for increase in self-purification. And who has (in mind) no favour from anyone to be paid back. Except to seek the Countenance of his Lord, the Most High. He surely will be pleased (when he enters Paradise)’’.

Islam also punishes thieves without discrimination between people, to purify the Islamic community and to maintain the property of people. Therefore, Islam requires high responsibilities and becomes more effective than the conventional punishment methods. Hence, Muslims should believe that whatever they did during their life must be with the Islamic values and norms.

4- Fairness: Islam encourages its believers to collective decision-making, tolerance, civil and political liberty, and to resolve problems by fair means. Surat Al- Imran, verse 159 says

“… and consult them in the affairs. Then when you have taken a decision, put your trust in Allah…"

Also, Islam is strict about independent justice. The Holy Qur'an in verse 58 in Surat An-Nnisa stated:

> "Verily! Allah commands that you should render back the trust to those to whom they are due; and that when you judge between men, you judge with justice….."

Islam regulates and influences all fields of a Muslim's life, including the governance and conduct of business. The Holy Qur'an in Surah An-Nur Verse 37 stated:

"Men whom neither trade nor sale (business) diverts from the Remembrance of Allah…", and in Surah Al-Baqarah Verse 275 stated;

"… Allah has permitted trading and forbidden Riba (usury)…"

Muslims have to conduct their business activities according to Islamic principles such as being fair and honest (Lewis, 2001). The influence of Islam regulation on the business activities is clear by prohibiting monopolies. The Holy Qur'an stated in Surah An-Nisa verse 29

"O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent."

From the above discussion, it could be said that the principles of good governance is not something new to Islam; therefore, it plays an essential roles in order to meet the objectives of corporation. Islam treats the rights of shareholders and stakeholders through implies that accountability not only to stakeholders but also to God, and advises an equivalent treatment of majority and minority shareholders by respect their individual welfare and balanced the distribution of wealth to stakeholders. Islam also encourages full, honest disclosure and transparency in every business transaction to provides that the corporation or institutions adherence with Islamic law. Islamic corporate governance focuses on the role and responsibility of the Shari'ah supervisory board members, as unique board, to supervise the operation of the corporation and ensure that the whole activities in corporation are in line with Islamic principles (Htay and Salman, 2013; Hasan, 2009). Shari'ah supervisory board as internal mechanism in Islamic institutions must make sure with other internal mechanisms such as Board of directors, management and internal audit that the corporation activities are in line with the Islamic rules. In the same hand, by having faith in the rewards and punishments, the good governance concept should play a major role in Islam.

Although, as explained above the principles of corporate governance is not new phenomenon in Islam, and the objectives of both systems of corporate governance seem similar in terms of providesefficient, effective management, adequatedisclosure and long-term corporate stability. However, the next points are main factors which may discourage the practice:

1- Islamic corporate governance model deals with complicated financial transactions that must comply with Islamic rules, such as prohibiting interest and uncertain transaction. This requires to adapt with Islamic accounting requirements. For instance, in Islam, financial reports should disclose to what extent financing activities and other concern issues are compatible with Islamic values.
2- Although Islam has formulated a comprehensive code of ethics and instils in people accountability, responsibility, and fairness.

However, Islamic countries have poor record in regard of corruption and corrupt behaviour which would be damaging any attempts to implement a system of Islamic corporate governance[3]. Therefore, the Islamic countries should have a holistic educational system producing a spiritually-enhanced human being by collaboration between business organisations and educational institutions.

5- Conclusion:

The purpose of this paper has been to explain the features of corporate governance in Islamic values and explain the existence of principles of good corporate governance in Islam. The paper highlights that the corporate governance is not new in Islam. Also, the above discussion of the Islamic perspective on corporate governance has provided clear differences between the traditional corporate governance perspectives and the Islamic model of corporate governance. The differences have emerged from the understanding of the nature of corporation. In Islam, the corporation is a legal entity of shareholders with proportionate ownership according to participation and profit sharing ratios, whereas in non-Islamic economy, corporation is a mechanism established to allow different parties to contribute capital, expertise and labour for the maximum benefit of them.

The study shows that Islamic corporate governance is driven by faith-based rationalism instead of only economic rationalism. Also, Islamic model of corporate governance sees the social welfare to stakeholders as the main goal of corporation; and Shariah Board acts to ensure that the corporation activities adhere to Islamic principles.

[3]Islamic countries ranked in the bottom of corruption perception index (www.Transperncy.org)

The study explains that although corporate governance in the non-Islamic economy is driven by the competition and shareholder wealth maximisation criterion; corporate governance in Islamic economy is guided by the social welfare criterion to the community.

The paper also highlighted the obstacles of corporate governance practice, which include the complicated rules in business activities, which require improvement to meet the Islamic values. Therefore, Islamic corporate governance practices should emphasise the use of good governance not only to business enterprises but also to whole life activities. Islamic values must be fully taken into account in importing good governance. Islamic countries should have a holistic educational system producing a competent human-being through the collaboration between business organisations and educational institutions.

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