

CORPORATE GOVERNANCE IN ISLAM VIS-À-VIS THE MODERN CORPORATE WORLD

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ABSTRACT

The concept of corporate governance (CG) has gained critical interest and has become a debating point since the mid-1980s. It became an aspect of concern when the corporate world became aware of the importance of protecting the rights of all stakeholders. Islam calls for an effective combination of the rules pertaining to Tawhid and Shari'ah in the day-to-day life of Muslims in general and in business in particular. This study presents a basic understanding of Islamic CG and compares the Islamic concept of CG vis-à-vis the Organization for Economic Cooperation and Development principles.

Keywords: *Corporate governance, Islamic corporate governance, Shura, hisab*

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Introduction

Corporate governance (CG) is an aspect that helps in the successful management of a firm and in ensuring confidence among investors. CG is conducted by monitoring and controlling the operations of the firm. CG has gained critical interest and has become a debating point since the mid-1980s. It became an aspect of concern when the corporate world became more aware of the importance of protecting the rights of all stakeholders. Later on, the definition of stakeholders was broadened to include the environment, society, and minority shareholders, among others. The concept of CG gained traction in the early 1990s with the publication of the Cadbury Report (1992). Many other similar reports that improved the Cadbury report followed, and they eventually took the form of the Organization for Economic Cooperation and Development (OECD) Principles of Corporate Governance (2004). The OECD Principles received wide acceptance not only from the member countries but also from the European Union (EU), World Bank, the United States, and non-OECD countries (Morck, 2005). Since then, the concept has attracted a great deal of attention from practitioners and various communities, including researchers, the academia, students, and many others. The six OECD Principles (OECD, 2004) are as follows:

1. Ensure the basis of an effective CG framework,
2. Rights of shareholders and key ownership functions,
3. Equitable treatment of shareholders,
4. Role of stakeholders in CG,
5. Disclosure and transparency, and
6. Responsibilities of the board.

These principles were developed in conjunction with national governments and a plethora of international organizations in the field and the private sector with the intention to evaluate and improve the legal, institutional, and regulatory framework for CG. They also provide guidelines and suggestions for stock exchanges, corporations, investors, and other related parties in the

area of governance. These principles now form the basis of CG in OECD and non-OECD countries. The six principles provide incentives for the board and management to pursue objectives in the best interest of the company and its shareholders.

In the Islamic context, the principal source of law is the Holy *Qur'an* and *Shari'ah*. Put in Islamic terminology, an effective combination of the rules pertaining to *Tawhid* and *Shari'ah* should be present. For Muslims, *Shari'ah* is a binding and persuasive source of legislation. Muslims are expected to follow *Shari'ah* rulings in all aspects of their lives, including their economic activities. The injunctions of *Shari'ah* are based on the interest of man, both here and the Hereafter. It facilitates the maintenance of personal and private goals, without in any way ignoring the duty of social welfare. *Shari'ah*, among other things, is intended to protect and preserve life, intellect, progeny, and property. With preservation of property as one of the fundamental interests of man, it is also a basic objective of *Shari'ah*. This basic objective enables *Shari'ah* to occupy a vital and significant place in Islamic legal philosophy. Islam subjects human activities to a set of principles that have eternal application and cannot be violated on superficial grounds of expediency based on human assessment (Usmani, 2010). The sacred quality of these laws is explained by the presence of many domains of human life in which “reason” is often confused with “desire”. Therefore, unhealthy instincts are permitted under the guise of rationality to misguide humans to make wrong, dubious, and destructive decisions.

There is a limit to human reason. Areas exist where human reason is incapable of providing proper guidance or are even susceptible to grave errors. Global warming and climate change occurring as a result of unbridled human intervention are classic examples of these human errors. Due to the limits on human reasoning, the Creator has provided guidance through his revelations sent through his prophets. Muslims firmly believe that the Almighty has also given revelations through the last messenger, Prophet Mohammed (PBUH). These revelations are to be followed in letter and spirit, and cannot be violated or ignored because of one’s rational arguments or inner desires. These revelations encompass every sphere of life, including personal, familial, public, and socio-economic fields (Usmani, 2010).

Clear guidelines have also been made regarding decision-making processes in the Islamic context that are against the conventional approaches. Islam stresses the practice of justice and equality, truthfulness and transparency, and accountability and adequate disclosure. It prohibits all forms of deceit and exploitation. These guidelines are applicable to all walks of life, including personal, familial, societal, and business dealings. Therefore, discussing the three important terminologies of *Tawhid*, *Shari'ah*, and *Sunnah* is appropriate.

Tawhid, in simple parlance, is oneness and unity with God. According to al-Faruqi (1992), *Tawhid* is the general view pertaining to the ultimate reality, the truth, the world, space, and time. It also involves human history and destiny. Islam teaches that the universe is the creation of the God Almighty. According to the principle of *Tawhid*, the nature of human beings lies in their indebtedness and submissiveness to the Almighty. This submission enables humans to voluntarily follow His commands as well as the *Sunnah* in all aspects of life, including business activities. *Shari'ah* is the Islamic teaching that covers all aspects of day-to-day human life. It covers not only religious rituals but also many aspects of daily life, politics, economics, business, and many social issues. *Sunnah* is the way of the Prophet Mohammed (PBUH). Muslims are expected to follow the *Sunnah* in their daily life.

Objectives of the Study

This study aims to compare the principles of CG in Islam vis-à-vis the modern corporate world. The main objectives are as follows:

1. To present a basic understanding of the concept of CG in Islam,
2. To gain a broader understanding of the building blocks of the Islamic system of CG,
3. To present an understanding of the concepts of *shura*, *hisba*, and the *Shari'ah* supervisory process and religious audit, and
4. To compare CG in Islam vis-à-vis the OECD principles.

Methodology

This theoretical research uses a literature review of existing studies as its methodology. Accordingly, the literature related to the theories and concepts of CG pertaining to the Western and Islamic models are reviewed. The focus is on the available literature in this field based on the Holy *Qur'an* and *Shari'ah*. The literature review explores the fundamental sources of Islamic principles and values with respect to the conduct of business based on the available texts and literature. It also compares the Islamic dimensions of CG with the OECD principles. Earlier studies, such as that of Abu-Tapanjeh (2009), have considered the OECD principles and compared them with the Islamic dimension of CG. The present study's unique form lies on its investigation of the Islamic dimension of CG and explores how it works with the OECD principles. This process of looking at Islamic CG significantly contributes to a comprehensive presentation of its complexity. It also helps in determining the breadth of the CG concept in Islam that has been found to be broader than that of the OECD principles. Attempts are also made to improve upon the available literature. This methodology is in accordance with a number of earlier studies in this field.

Business in Islam

As a comprehensive religion, Islam has laid down rules and regulations demanding adherence from its followers. Businessmen are no exception to this. Islam calls upon business entities to be ethical. For business activities to be ethical, they should be based on justice, leniency, and legitimacy. According to Lewis (2005), business should be done according to the general Islamic perspective of *halal* (allowed and praise-worthy) and *haram* (prohibited and blame-worthy). Businessmen should only act on a permissible profit-oriented motive and mutual consent. They should not be involved in coercion, fraud, or falsehood (Ahmad, 1995). Islam in no way denies the market forces and market economy. However, it provides strict control over business and trade. Business activities should be ethical and be based on justice, leniency, and legitimacy. They should also possess the qualities of permissible profit orientation, i.e., with mutual consent and with no element of coercion, fraud, or falsehood.

Business should be fair, honest, and just. Assets should in no case be usurped and should only be earned lawfully, with the economic benefits going to its owners. Other certain positive business virtues should be observed, and negative values should be eliminated (Htay & Salman, 2013). These virtues include *iqtisad* (moderation), *adl* (justice), *ihsan* (kindness), *amanah* (honesty), *infaq* (meeting social obligations), and *sabr* (patience). The negativities to be avoided are *zulm* (tyranny), *bukhl* (miserliness), *hirs* (greed), *iktinaz* (hoarding), and *israf* (extravagance).

Therefore, the primary feature of an Islamic economy is to provide a just, honest, fair, and balanced society grounded on Islamic ethical values and rules. Islamic economics is considered to be Godly, ethical, humane, moderate, and balanced. All Islamic business systems should revolve around the ethical rules of *Shari'ah*. Apart from ethics, Islamic business is also characterized by social commitments grounded on the ethical and moral framework of the *Shari'ah* (Ahmad, 2000; Warde, 2000). This view was also expressed in an earlier study by Asyraf (2006). Muslim businessmen should accord paramount importance to high moral values aside from honesty and fairness in all business dealings. Islamic tenets prohibit Muslim businessmen from deceiving or exploiting others. Markets should be free and not subject to any forms of manipulation. Furthermore, to prevent the powerful from exploiting others, price fixing and monopolies are completely prohibited (Lewis, 2006). Even economic activities are included in the purview of religious controls, so that personal and individual interests do not contradict the collective interests of the society. The Islamic economic system enables people to earn their living fairly and profitably. It prevents exploitation in all forms to protect the whole society.

Any product traded should be useful and in no way harmful, as defined in the Holy *Qur'an* and Islamic law. Trading and investment should be undertaken only in legal activities. Activities such as gambling, dealing with alcohol, pornography, and so on are prohibited because they are harmful to society. Vocations should provide dignity of labour. Islam also calls on employers to be just to their employees aside from emphasizing to the former their prompt payment of fair wages to the latter.

Islamic values expressed ethically are an integral part of the obligations laid upon the individual and the community. Rules of CG are derived from

the underlying principle of assuring the economic well-being of the entire community based on universal brotherhood, justice, mutual accountability, truthfulness, transparency, protection of minorities, adequate disclosure, and equitable distribution of wealth.

Modern Concept of CG

Good CG means good business, and it significantly helps to prevent corporate scandals, fraud, and the resultant civil and criminal liability toward organizations. A good CG image enhances the reputation of the organization and makes it more attractive and acceptable to all stakeholders, including customers, investors, and suppliers. A corporation with good CG can help the organization to maintain an effective management structure and activity system, which will subsequently facilitate the corporation's ability to meet the needs of all its stakeholders. Corporations that focus on achieving the principles of CG through the prescribed guidelines will be capable of keeping pace with the changing times.

The underlying principles of CG, as provided above, have been identified by OECD after careful research and deliberations. CG also deals with all the legal and organizational structures that nurture the internal integrity of a corporation. In the current globalized scenario, the implications and repercussions of poor CG may not be limited to local or national boundaries. CG could transcend national borders. A classic example of this transcendence is the economic tsunami that occurred in the global financial markets caused by the collapse of Lehman Brothers.

In the Western world, CG has two distinct models: the Anglo-American and Franco-German models. A number of theories have also been propounded with respect to CG, and they include transaction cost theory, political theory, and resource dependency theory, among others. The Anglo-American model focuses on the maximization of shareholder value, and the Franco-German model also provides a certain element of focus on the interests of the stakeholders. Despite the absence of an official juristic recognition of CG in Islam, an examination of the Holy *Qur'an* and *Sunnah*, which are the sources of Islamic jurisprudence, reveals clear guidelines to help stakeholders in the process of decision-making. The following sections provide an understanding of the Islamic concept of CG.

Islamic CG

CG in Islam is unique and presents distinctive characteristics compared with the Western concept. The principles of CG are not new or unfamiliar to Islam. Whereas the debate is centered mainly on agency issues in the conventional CG model, the Islamic view focuses on stewardship or trusteeship. According to Islamic tenets, wealth belongs to the Almighty and everyone. Regardless of position or stature, the director, manager, shareholder, or any other stakeholder is the trustee of this immense wealth. This assertion makes the Islamic concept of CG fundamentally different from others. Islamic CG is rooted in justice and fairness. It has a wide commission with obligations normally extending beyond shareholders, financiers, and management to a host of other stakeholders, such as suppliers, customers, competitors, and employees. Furthermore, it should embrace the spiritual and temporal needs of the individual and the community at large.

All Muslims believe that human life aims to achieve *falah* (success and eternal happiness) in the Hereafter. They believe that the world is a journey to reach the final destination of the Hereafter. *Falah* calls upon Muslim businessmen and directors of companies to be spiritually motivated to comply with all *Shari'ah* rules and regulations in their daily lives. They are expected to bear this in mind while conducting routine business dealings, making complex economic decisions, and managing the company's affairs. Moreover, conducting business dealings according to the *Shari'ah* principles will absolutely eliminate the possibility of causing any harm to others. At the same time, it will bring in a plethora of benefits to all the parties involved in terms of both physical and spiritual wealth. *Falah* can also effectively influence the minds and attitudes of businessmen and prompt their decisions toward good CG. Overall, *falah* in the Hereafter acts as a spiritual motivating factor toward awareness about *hisab* (accountability).

The basic building blocks of the Islamic system of CG are the concepts of *shura*, *hisab*, and the *Shari'ah* supervisory process and religious audit. Most of these constructs have been discussed earlier. Converted into the current CG practices, these constructs translate to transparency, accountability, and trustworthiness. Each construct is discussed in the following sections.

Shura

In simple parlance, *Shura* means mutual consultation and consensus. *Shura* involves the selection of representatives and the use of consultation in the formulation of policies. The concept can be found in the Holy *Qur'an* (42:38): “*Those who respond to the Lord, and establish regular prayer, who (conduct) their affairs by mutual consultation; who spend out of what We bestow on them for sustenance.*” *Shura* is capable of providing transparency in all operations, given that crucial decisions can only be made after careful deliberation and discussions. As decisions are made with due deliberation, decisions tend to be reinforced with the aspects of justice, equality, and human dignity. Therefore, the process of *Shura* can be considered as the most profound Islamic institutional and organizational model of governance in general and CG in particular. The basis and overall functioning of Islamic governance are based on *Shura*. The net result of *Shura* is transparency. This built-in openness and transparency in business dealings with members, shareholders, and other stakeholders increases the effectiveness of CG.

Shura is one of the four cardinal principles in the Islamic perspective on socio-political organization. It is rooted in the Holy *Qur'an*, and various modes of consultations are mentioned in it. Prophet Mohammed (PBUH) used to consult with his companions on various occasions. The Muslim community is described as, among its other attributes, one that administers its affairs through mutual consultation. This consultative procedure is conducted to specifically and undoubtedly adapt Islamic basics. Furthermore, for Muslims, the religious dimension of existence broadly extends to encompass the whole gambit of life. Therefore, the principle of *Shura* calls upon Muslims to have all issues, whether social, economic, or political, be ultimately related to the basic Islamic conceptions. Dealing with issues within the basic Islamic ideas will facilitate the achievement of unreserved societal and public acceptance and support.

The three main advantages of the *shuraic* decision-making process (Mawdädi, 1974; Shaikh, 1988) are presented in Table 1.

Table 1: Advantages of the Shuraic Decision-making Process

No.	Qualities	Description
1.	Ethics	The basic Islamic precept of justice states that, in the best interest of ethics, those who are to implement the decision and those most affected by the particular decision should participate in the process of decision-making.
2.	Consultation and consensus seeking	Islam views the process of consultation and consensus seeking as having the capacity to prevent the deplorable act of one or a small group(s) of individuals from overriding the due rights of others. This process is also capable of preventing the imposition of the will of such group(s) on others for selfish motives.
3.	Trusteeship	Islam considers decision-making to be an important trust from the Almighty. Per Islamic tenets, those holding this trust should involve all the participants, and decision-making should involve the qualities of truthfulness, justice, consultation, and a spirit of consensus seeking.

The following is a recent example. Had the concept of *Shura* or consultancy been in place in Satyam (Bhashin, 2013), the episodes of corrupt practices that led to a series of incidents that shattered investor confidence and culminated in the merger of the company would have been avoided.

Hisab

The Holy *Qur'an* clearly considers humans to be accountable (*hisab*) for their deeds before the Almighty. The word *hisab* is repeated a number of times in the Holy *Qur'an*. The direct meaning of *hisab* is "account." *Hisab* relates to one's obligation to "account" to the Almighty all earthly matters and accounts. Therefore, according to the Holy *Qur'an*, human beings are "accountable" for all their words and deeds. Those who have attempted to describe Islamic accountability (e.g., Abbassi, Rehman & Bibi, 2010; Nahar & Yaacob, 2011) have opined the inherent duality of Islamic accountability. The primary accountability is towards the Almighty given that man is a trustee (*khalifah*) entrusted with all worldly resources. The secondary accountability is the contractual relationship that human beings may have with organizations, managers, employees, local community, and environment, among others (Hameed, 2000, 2001).

Per the tenets of Islam, man is made the trustee (vicegerent) of all resources of the earth based on verse 33:73 of the Holy *Qur'an*. God subjects everything He has created on earth to the trusteeship of human beings. Verse 2:30 of the Holy *Qur'an* proclaims humans to be as follows: *“Behold, the Lord said to the angels: ‘I will create a vicegerent on earth.’”* All human beings are expected to accomplish this responsible role of vicegerent or trustee justly, wisely, and with “accountability to God Almighty”. This accountability does not stop here. Trust should be returned with due care and responsibility. *Sura An-Nisa: 58* exalts humans as follows: *“Allah doth command you to render back your trusts to those to whom they are due; and that when ye judge between people, that ye judge with justice. Verily, how excellent is the teaching which He (Allah) gives you! Truly, Allah is he who heareth and seeth all things.”*

This assertion was highlighted by Prophet Mohammed (PBUH) when he taught, “Each one of you is a guardian and each guardian is accountable to everything under his care.” Furthermore, according to *Qur'an* (21:47): *“We shall set up scales of justice for the Day of Judgment, so that not a soul will be dealt with 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.”* This *Qur'anic* injunction extols Muslims to make their business policies and affairs fair, just, and honest. Moreover, Islam does not inhibit people’s right to use nature to accumulate wealth. In fact, Islam encourages people to use nature fully as long as it is within the limits prescribed in the Holy *Qur'an* and *Sunnah* (Al-Faruqi, 1992).

Islam prevents exploitation in whatever form, and humans are expected to behave responsibly and with accountability. Applying this principle in the corporate world, businessmen are expected to exercise a high level of accountability when undertaking business operations. Apart from the expected accountability to the various stakeholders, they are also expected to act in a way beneficial to the public at large and the broader society. As far as Islam is considered, the primary accountability is voluntary and paramount, and applies to Muslims in general and businessmen in particular. The main difference between Muslim and non-Muslim businessmen are considered as follows: whereas Muslim businessmen believe in superimposing religious activities in the daily activities, non-Muslim businessmen focus on a secular worldview.

The voluntary imposition of accountability, which makes a person answerable before the Almighty, enables businessmen to facilitate the disclosure of true and correct information of financial facts. This information is freely available to all stakeholders to facilitate sound financial decisions. This situation leads to the accurate payment of *Zakat*, which is one of the basic pillars of Islam.

Trustworthiness

The concept of trustworthiness can be found in *Sura al-Anfal* (8:27): “*O ye who believe! Betray not the trust of Allah and the Messenger, nor misappropriate knowingly things entrusted to you.*” According to *Sura al-Baqarah* (2:282): “*O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties: let not the scribe refuse to write: as Allah has taught him; so let him write. Let him who incur the liability dictate, but let him fear Allah his Lord and not diminish aught of what he owes.*”

All Muslims are expected to conduct a *Shari’ah* supervisory process and religious audit over all their activities. Such an activity has the capacity to bring in trustworthiness in their decisions and dealings. Compliance with *Shari’ah* norms facilitates morality in the personal and professional life of any Muslim. History is replete with examples of mighty corporations, governments, and civilizations collapsing because of their laxity in moral norms or *Shari’ah*. If moral norms are not reflected in the laws, or if such laws are not implemented effectively by the political authorities, individuals and organizations could be led to a variety of morally objectionable behaviours, including dishonesty, fraud, unfairness, and so on. Classic examples are the Enron and Lehman Brothers cases in the United States and Satyam issue in India.

Comparison between Islamic CG and OECD Principles

Abu-Tapanjeh (2009) attempted such a comparison, but it was between OECD principles and the Islamic concept, with OECD principles as the foundation. Alternatively, the present study made a different dimension of comparison. A comparison was made between the Islamic concept of CG

(with Islamic concept as the foundation) and the OECD principles. The comparison is presented in Table 2.

Table 2: Comparison between Islamic CG and OECD Principles

Islamic principle	OECD Principle	OECD Principle No.
<i>Shari'ah</i> – primacy of ethics, justice, and social welfare with social and spiritual obligation	Ensuring the basis for an effective CG framework Equitable treatment of all stakeholders Responsibilities of the board	1 3 6
<i>Khalifah</i> (Vicegerency) – property as trust from the Almighty	Rights of shareholders and key ownership functions. Primary accountability to God and then to stakeholders Responsibilities of the board	2 6
<i>Zakat and Sadaqa</i>	Equitable treatment of all stakeholders Responsibilities of the board	3 6
Falah	Role of stakeholders in CG Responsibilities of the board	4 6
<i>Hisab</i> – Accountability	Disclosure and transparency Responsibilities of the board	5 6

Table 2 shows that the Islamic concept of CG encompasses all the principles of the OECD in multiple dimensions. A single Islamic principle is found to include multiple OECD principles. The meaning of one Islamic principle is much broader than all the OECD principles. For example, the concept of vicegerency (*khalifah*) or trusteeship is primarily the “accountability to God Almighty” and then to worldly resources. This meaning has no limit, and all activities of an individual, whether business or otherwise, can be included in this concept. The same holds true for the concept of trustworthiness. The Holy Qur’an (*Sura al-Anfal, 27*) extols humans by stating: “*Betray not the trust of Allah and the Messenger, nor misappropriate knowingly things entrusted to you.*” These comparisons reveal the comprehensiveness of the Islamic CG vis-à-vis the modern CG. The Islamic principles provided above

can absorb other principles that can emerge from the modern concept of CG. Notably, these principles have been envisaged in previous centuries, even before people started thinking about the need for or importance of CG.

Based on the previous discussions, a possible model of how Islamic CG can be viewed is presented in Figure 1. All principles are derived from the Holy *Qur'an* and the *Shari'ah*.

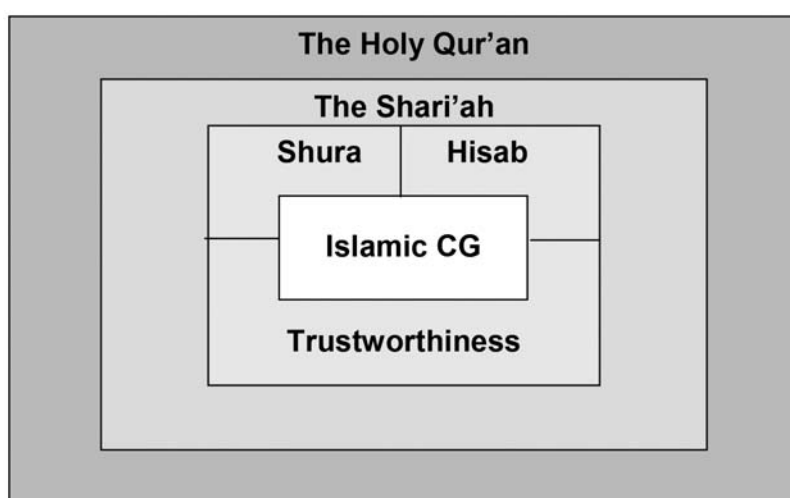


Figure 1: The Concept of CG in Islam

Conclusion

For centuries, Islam has presented a comprehensive and holistic set of distinctive values and special characteristics, such as *falah*, *Shura*, *Khalifah* and *hisab*, among others, which have been brought forth by *Qur'anic* texts and elucidated by the *Sunnah* of Prophet Mohammed (PBUH). All these Islamic principles, as well as *Zakat* and *Sadaqa*, include multiple principles of modern-day CG. These principles presented by Islam have formed the basis of the present-day concept of CG and even exceed the OECD principles in their current form. God Almighty has done this with the aim of upholding and maintaining the principle of social justice to all stakeholders.

The observance of fundamental Islamic business practices has had a worldwide resurgence. However, most business practices remain far from the Islamic ideal even in the Muslim world where business thrives under unbridled capitalism. Febianto (2011) describes this gap between the ideal and reality to be widening at a rapid pace. This gap is increasingly becoming a threat to the well-being and stability of Muslim societies. The model of Islamic business practices in general and CG in particular, if appropriately implemented with seriousness, can significantly contribute to overcoming the multitude of problems faced by the modern corporate world.

Note: The “**THE HOLY QUR‘AN, English Translation of the Meanings and Commentary, revised and edited by The Presidency of Islamic Research, IFTA, Call and Guidance, King Fahad Holy Qur‘an Printing Complex** was used for the *Qur‘anic* translation.

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