AN ANALYSIS OF CORPORATE GOVERNANCE IN ISLAMIC AND WESTERN PERSPECTIVES

Dr. Malik M. Hafeez
Advocate/Legal Consultant,
The Islamia University of Bahawalpur

ABSTRACT

Corporate governance is a set of relationship between a company’s boards, its shareholders, and other stakeholders as well as provides the structure and mechanism through which the objectives of the company are set and the means for attaining those objectives and monitoring performance are determined. The development of corporate governance has been effected by theories from a number of disciplines including finance, economics, accounting, law, and management and organizational behaviour. The Islamic jurists claim that the Islamic law (Shari’ah) provides comprehensive system to cover not only religious rituals but also many aspects of social and economic life, politics, business and contract law. The Sharia code of conduct encourages every Muslim to be just, fair and honest to all the people involved in business transactions. The Islamic system of governance encourages and promotes the ethical norms of transparency and honesty in every business transaction. The Islamic principles of corporate governance determine the three dimensions of decision-making: a) by whom; with mutual consultation of Shura or Consultative Council, b) For whom; the ultimate aim of any corporate activity is to gain grace of Almighty Allah and the decision makers on the earth regarded as trustees of the given powers to take decisions in the best interests of His people and c) with whom and to who; the corporate governance decisions require an effective religious supervision to ensure the conformity of all operations and procedures to the Sharia. Similarly, the Western corporate governance focus on corporate transparency, effective monitoring, efficient management, sound system of internal control and risks management through competent board of directors who should be free from conflicts of interests and possess skills and experience to run the corporate affairs in competitive environment.

Key words: corporate governance; objectives; supervisory boards; board of management; corporate governance in Sharia; Shari’ah board; Al-Amal Al-Jama’e’e

1. Introduction

The term “corporate governance” and its everyday usage in the business world are new phenomena of the last decade and half. Corporate ownership structure is considered as having the strongest influence on corporate governance system, although many other factors affect governance including legal systems, cultural and religious traditions, political environment and economic events. Corporate governance is a set of relationship between a company’s boards, its shareholders, and other stakeholders. It provides the structure and mechanism through which the objectives of the company are set and the means for attaining those objectives as well as monitoring performance are determined.

2. Features of Corporate Governance

Good corporate governance is essential to attract new investment particularly for developing countries. The development of corporate governance has been effected by theories from a number of disciplines including finance, economics, accounting, law, and management and organization behaviour. Following are the features of corporate governance:

i. It helps to ensure that an adequate and appropriate system of control operates with in a company;
ii. It also prevents any single individual from wielding too powerful an influence;
iii. It is concerned with the relationship between company management, board of directors, share holders and other stake holders;
iv. It aims to ensure that the company is managed in the best interest of shareholders and other stake holders;
v. It tries to encourage both transparency and accountability;

3. Corporate Governance in Western Perspective

Today, Corporate Governance has evolved to a level where the outcome internationally appears to be “a system which assures corporate decisions are efficient and effective”. At the same time, the foundation for the practices seem to be resting on the philosophy that corporate decisions need to be internally challenged in an effective manner in order to assure and establish its validity and long term sustainability. Corporate governance has concern with a set of behavioural patterns and normative framework. The behavioural concerns relate to actual behaviour of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. While the normative framework has concern with rules and regulations under which firms are operated and governed. This regulatory framework is outcome of the

1 Thomas Clark, Theories of Corporate Governance, (Routledge 2004) 1-20
2 Ajith Nivard Cabraal, Corporate Governance in Sri Lanka, Fast off the Tracks: But is the Progress Real Progress?, in Farooq Sobhan and Wendy Werner, (eds.) A Comparative Analysis of Corporate Governance in South Asia: Charting a Roadmap for Bangladesh, (August 2003) at pp. 274
3 Farooq Sobhan, Diagnostic Study of the Existing Corporate Governance Scenario in Bangladesh, in Farooq Sobhan and Wendy Werner, (eds.) A Comparative Analysis of Corporate Governance in South Asia: Charting a Roadmap for Bangladesh, (August 2003) at pp. 12-68
legal system including judicial structure, financial markets, and factor (labour) markets. The behavioural structure of corporate governance is most logical which considers matters such as how boards of directors operate the role of executive compensation in determining firm performance, the relationship between labour policies and firm performance, and the role of multiple shareholders while the normative framework provides institutional framework that affects the behavioural patterns of firms, investors, and others. Both institutions and rules evolve over time. However, institutions do not arise in a vacuum and are affected by the rules in the country or the world as legal framework is affected by the country’s institutional setup. In sum, both institutions and rules are endogenous to other factors and conditions in the country. The ownership structures and regulatory structure of state matter for the evolution of institutions and rules through the political economy process.

The primary participants of the corporate governance are the shareholders, management and the board of directors. The board structure and procedure vary in common law countries and civil law countries and it may be a dual or unitary board. In civil law jurisdiction, some countries have two tier boards that separate the supervisory functions and management functions into different bodies. Dual/two-tier boards comprise of a ‘supervisory board’, which is composed of non-executives board members with representation of employees, and a ‘management board’ that is entirely composed of executives. On the other hand a unitary board is of single tier, which bring together executives and non-executives board members. In some countries there is also an additional statutory body for audit purposes. For instance, the external audit board works in Italy.

Usually the shareholders like the unitary board elect the supervisory board, in a two-tier system. The board of directors and the supervisory board lead and control the company while the board of management in dual system and chief executive in unitary system is responsible for the running of the day-to-day affairs of the company. The chairman of the board of directors is responsible for the running of the board whilst the CEO who is the head of the management is responsible for the running of business. As the number of shareholders in a company increase, it is obviously impossible for all to be involved in the management and the control of the company’s affairs. Therefore a separation will develop between those who own the company (the shareholders) and those who manage it (the directors).

The non-executive directors bring balance to the board and their experience and knowledge can add value. They make key contributions being the members of the boards sub-committees. They do not have executive management responsibilities but are concerned with the general management policy and strategy as well as monitoring of the executive directors. Executive directors are those directors who are concerned with the actual management of the company. They will have extensive management powers delegated to them by the articles or other contracts.

The board of directors are a crucial part of the corporate structure. They are the link between all the stakeholders. Its primary role is to monitor the management of the company on behalf of shareholders. In fact, the strength and survival of any corporation depends on a balance of two distinct powers: the power of those who owns the corporation and the power of those who run it. A corporation depends on shareholders for capital, but reserves the day to day running of enterprise for management. Adams Smith (philosopher 1723-1790) criticised both those who invested in joint stock companies, and those who manage them. About the investor he wrote that “they seldom pretend to understand anything about the business of the company:” and of the directors he said, that “being the managers of the other people’s money rather than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partner in a private co- partnership frequently watch over their own.” In British Jurisdiction, the modern concept of corporate governance started from the establishment of the Cadbury Committee 1992. The recommendation of the Cadbury Committee exported the modern practices and norms of corporate governance to the rest of the World. The Cadbury Committee considered a variety of issues in relation to financial reporting and accountability and to make recommendations on good practice in respect of the responsibilities of executive and non-executive directors for reviewing and reporting on performance to shareholders and other financially interested parties. The contribution of Hampel Committee was to draw up the combined code that now applies to all listed companies. Recognition is given to the fact that there are two key tasks at the top of every public company: the running of the board and the executive responsibilities for the running of the company’s business and a decision to combine these two roles in one individual should be publically explained. The Higgs Report published in January 2003, contains many recommendation and much guidance as to the role of the board, the chairman and non-executive directors. Para 5.7 of the Higgs Report states that the Chief Executive of a company should not move up to become chairman. The chairman should be independent on appointment and executive director should have only one non-executive post. The division of responsibilities between the chief executive and the chairman should be clearly established and set out in writing and agreed by the board. The Smith Report on Audit Committees considered that the audit committee should consist of at least three independent non-executive directors. Their main role and responsibility will be to monitor the

---

4 Ali Cheema, Faisal Bari and Osama Siddique, Corporate Governance in Pakistan: Ownership, Control and the Law in Fanoq Sobhan and Wendy Werner, (eds), A Comparative Analysis of Corporate Governance in South Asia: Charting a Roadmap for Bangladesh, (August 2003) at pp. 171
5 Christine Mallin, Corporate Governance, (Oxford 2007) 188-218
6 Jill Solomon, Corporate Governance and Accountability, (Wiley 2007) 78
7 Jill Solomon, (n. 6) 210
8 Bob Tricker, Corporate Governance, (Oxford 2008) 25-66
9 Bob Tricker, (n. 8) 52-64
10 The Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury, set up in 1991 by the Financial Reporting Council, the London Stock Exchange and the Accountancy profession.
integrity of the financial statements of the company; to review the company’s internal financial control system and risk management systems; to monitor and review the effectiveness of the company’s internal audit functions; to make recommendations in relation to the appointment of the external auditor and to monitor the auditor’s independence, objectivity and effectiveness and to develop and implement policies on the engagement of the auditors for non-audit services.

The European Commission recently initiated a review of corporate governance codes throughout the EU and found that every member state except Austria and Luxembourg had at least one code and that there were in excess of 35 codes in total. However, the review also revealed that the codes were remarkable for their similarities and served as a converging force for governance practices across the EU. The report considered that it would be more valuable for the commission to focus its efforts on the reduction of participation and information barriers which prevent shareholders from having a greater role in corporate governance.

An executive officer who is called CEO / MD is simultaneously an employee, a director and an agent of the company. This can be contrasted with the role of the non-executive director, who is member of the board but not an employee nor an agent of the company. Basically the directors are representative of the owners according to the principles of agency and they are the middle man who provides balance between small groups of the key managers and vast groups of share holders spared all over the world. Legally most jurisdictions describe the director as having two duties: the duty of care and duty of loyalty but their conduct will be judged according to the “business judgment rules”. Many people have tried to step beyond the legal definition of the board’s duty and develop more specific description of the obligations and responsibilities of the directors.

The principles of Organisation for Economic Co-operation and Development (OECD) contains that corporate governance should protect the rights of shareholders, ensure the equitable treatment of all share holders including minority and foreign share holders. It should also recognise the rights of stakeholders and ensure the timely and accurate disclosure and transparency about all materials matters regarding the corporation. Good corporate governance should ensure the strategic guidance of the company, the effective monitoring of the management by the board and the board’s accountability.

In various countries, the CEO of some of the largest companies is also the chairman of the board but in England by contrast the figure is roughly reversed with only one third of the largest companies having a joint chief executive and chairman. It is a well-settled principle of law that absolute power in one hand corrupts absolutely. In corporate governance, corporations cannot be run by consensus. Managers must be given the power to make decisions quickly and to take reasonable risks. If every managerial decision had to be communicated to the company’s owners, too less will be ratified by them and industrial progress would be paralysed and every one would lose.

4. Corporate Governance in Shari’ah (Islamic Law)
The Islamic jurists claim that the Islam as a religion is a complete code of life that covers all sphere of social, economic and legal structures including trade and commerce. The Islamic law (Shari’ah) provides comprehensive system to cover not only religious rituals but also many aspects of social and economic life, politics, business and contract law. The Islamic business principle direct to the business community to conduct their business in accordance with the Shari’ah rule of fair trade, honest and just towards others. The accumulation of wealth subject to constraint restrictions is allowed in Islamic system because wealth is regarded as a trust and a test for wisely utilisation of wealth to benefit the society and poor people rather than to make wealth. The Islam always encouraged the business community to conduct trade and commerce in accordance with the injunctions of Islam i.e. Holy Qur’an and Sunnah.

Corporate governance in Shari’ah provides comprehensive guidelines with encompassing duties and practices. For instance, how to deal with economic transactions up to the moral conduct of a Muslim without defining the modern corporate governance, rules of Shari’ah impetus corporate governance in each and every individual actions of Muslim up to the social environment. The Islamic system believes that the absolute and eternal owner of everything on earth and on the heaven belongs to Allah Almighty and human beings are just vice regent of it. The Sharia code of conduct encourages every Muslim to be just, fair and honest to all the people involved in business transactions. In other words, the Islamic law lessons to preserve a high moral conduct that prohibit to betray, deceive or exploit his fellowship and the profit making on the cost of moral and business values. The Muslims are required to work honestly to enhance productivity rather than becoming lethargic and unproductive. It is argued that any system without an appropriate an ethical and moral climate would not be able to influence a proper system of governance. It could be argued that the Islamic system of governance encourages and promotes the ethical norms of transparency and honesty in every business transaction.

The decision-making is a significant element of corporate governance that should be taken either with consensus of board of directors or with majority members. The Muslims believe that the Islamic code of life mandated by the holy Qur’an and Sunnah govern every aspect of their life. This is a reason that the ethical notion of corporate governance assumes a vast and holistic significance in Shari’a. However, the superior-officials possess decision-making in Shari’a that extends their responsibility to

---

13 Gotshal and Managers, Comparative study of corporate governance codes relevant to the EU and its member states (Jan.2002)
14 Michael A Adams, Essential Corporate Law, 2nd ed. (Cavendish Australia 2005)
16 Abdussalam Mohmoud Abu-Tapanjeh, (n. 15) 561
17 Abdussalam Mohmoud Abu-Tapanjeh, (n. 15) 561
18 Abdussalam Mohmoud Abu-Tapanjeh, (n. 15) 562
comply with obligations in the best interest of all stakeholders and beyond shareholders. The well-settled principle of Islam is that the human-beings are the trustee of God on earth in all situations and everything in this universe belongs to Allah. The ethical norms of Islamic system expect that all Muslims should be taught to maintain and strengthen good relationship with elders, superiors, clients, and the management in accordance with the divine norms and rules. Their conduct should be inspiring to the whole community with the values of truthfulness, fairness, tolerance and justice to distinct that the decision-making process of Islamic institutions in a different and broader ways than conventional model of decision-making in corporate governance.

To answer the question that by whom the decisions should be taken; the verses of the holy Qur’an provide clarity in following terms:

“…And consult them on affairs (of moment). Then, when you have taken a decision, put your trust in Allah.”

Those who respond to their Lord, and establish regular prayer; who conduct their affairs by mutual consultation; who spend out of what we bestow on them for sustenance.

The verses mandated that the decision should be taken with consensus by those good men who respond to God and fear God and who can conduct fair mutual justice with equal importance to all. The word ‘consultation’ denotes the key word of Shura (consultative council) comprises on good men. This principle is applied to its full extent not only by the Prophet (PBUH) in his public and private life but also by the early Khalifas (Rulers) of Islamic states. However, the origin of consultative process through Shura or Consultative Council comprising on a group of tribal elders is found in pre-Islamic times. Originally, problems arrived in the council and members were invited to discuss and express their opinions which were thrashed out till the reaching of consensus. This process of Shura or consultation encouraged the participants and expects them to work together freely and frankly to reach the conclusion of the matters.

On the other hand, the core element of corporate governance is an institution of Hisbah that was established in Abbaside regime at (750 A.D.) to ensure the compliance with Shariah (Islamic-law) requirements in corporate and business affairs relating to correcting weight and measures, fair trading rules, checking business, frauds, auditing illegal contracts, keeping free-market, and storage of necessities for black-marketing. Lewis quoted the Mawdudi arguments which provide clarity for the understanding of decision-making in Shariah in following manners:

“Mawdudi argues that there are three reasons behind the shuratic decision-making process (Mawdādi, 1974, cited in Shaikh, 1988). First, on ethical grounds and in line with the basic Islamic precept of justice, those most affected by a decision, and/or those duty it is to implement the decision, should participate in its making. Second, consultation and consensus-seeking prevents one or a small group of individuals from over-riding others rights and imposing their will on others for selfish motives or because of a belief that their views carry more weight. Such behaviour is deplorable in Islam. Third, decision-making is an important trust from God, and Islam demands from those holding this trust to engender truthfulness, justice, consultation and a spirit of consensus-seeking among participants during group decision-making.”

In economic system of Islam, accountability is a key element to produce true and fair account to the all stakeholders through disclosure and transparency. Every Muslim believes that all resources in this universe available to every individual should be regarded as a trust and the trustees of such resources are accountable to the God. This principle of accountability is also applied in Islamic corporate governance system to produce true and fair disclosure of financial facts and accurate information to all stakeholders for sound and consistent financial decisions e.g. payment of accurate Zakah, Khairatt etc. The Islamic system believes on keeping up-to-date, fair and just financial transaction records. The holy Qur’an provides this principle in following manners:

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

“…And if you are travelling and cannot find a scribe, then there be a mortage taken….. And do not conceal any evidence for the whoever hides it, surely his heart is sinful, and Allah is all knower of what you do.”

The said verses mandated that the all business transaction should be written down and kept in record by a good man who possesses honesty, credibility, high moral conduct and can be just fair to everyone. The business profits should be earned in law

---

20 Abdussalam Mohmoud Abu-Tapanjeh, (n. 15) 562
21 Al-Qur’an, 3:159
22 Al-Qur’an, 42:38
23 Mervyn K. Lewis, ‘Islamic Corporate Governance’ Review of Islamic Economics, 2005, 9(1) 5-29 at pp.15
24 Mervyn K. Lewis, (n.23) 15
25 Shaikh M. A, ‘Ethics of Decision-making in Islamic and Western Environments’ American Journal of Islamic Social Sciences 1988, 5(1) 115
27 Mervyn K. Lewis, (n.23) 16
28 Al-Qur’an, 2:282
29 Al-Qur’an, 2:283
30 Al-Qur’an, 21:47
31 Al-Qur’an, 5:8
full way that will go to the ownership of capital providers (investors or partners) rather than usurping the assets of parties. Islamic system believes that unlawful acquisition of wealth would cause widespread inequalities and social injustice. The Islamic law provides that the accounting practices, financial reporting and disclosure should be undertaken in terms of objectives based in accordance to the injunctions of Islam, to promote social and economic justice through providing equal opportunities of earning profits and equal distribution of wealth to all citizens of state.\(^{32}\)

The Islamic system of economic trade and commerce is very similar to the system of capitalistic society. It enables the investors to earn profits similar to the western system of corporate governance in which investors have superior right in wealth maximisation. However, the Islamic system of corporate governance recognised rights of stakeholders for which the best institutional arrangements can protect their rights to yield optimal result of corporate stability, social and economic justice. It is argued that ‘a firm should internalise the externalities on the various stakeholders and this internalisation should be in form of active participation in the process and structure of corporate governance’. \(^{33}\) The Islamic system believes on the protection of all stakeholders’ interest through internal organisational arrangements either in form of active participation in the process and structure of corporate governance or negotiation with shareholders to safeguard their interests. \(^{34}\) However, the concept of Zakah and Khairatt protect the financial rights of deserving non-shareholders stakeholders in the profits of corporations and their shareholders.

The Islamic economic and corporate governance system entails implementation of a rule-based incentive system to ensure an efficient governance system to preserve social justice. \(^{35}\) The Islamic rule-based system of corporate governance inflicts the organisational framework to compel managers to internalise the welfare of all stakeholders. The observance of rules of behaviours ensures internalisation of stakeholders’ rights that need institutional arrangements. The stakeholders-model of Islamic corporate governance envisaged the fiduciary duties to the corporate managers to run the affairs of companies in the best interest of all stakeholders. However, every stakeholder has freedom to protect his right through systematic institutional arrangements to resolve any conflicts of interest among all stakeholders. \(^{36}\) Apart from normative approach of corporate governance, the Islamic religious beliefs are regarded as self-regulatory model with the fear of accountability to Almighty Allah at day of Judgement or even in life-time. However, the concept of religious self-regulatory approach provides freedom to all human-beings to follow the Islamic principle in their day-to-day affairs.

On the other hand, the concept of Shari’ah-board is unique to Islamic financial system in which board comprising of ‘fuqaha’ (jurists) to keep check and balance to ensure the operations of the institutions in accordance with the rules of Shari’ah. \(^{37}\) However, the model of Shari’ah-board could be extended to the model of supervisory board in German-model consisting of scholars or experts from different disciplines including Shari’ah, economic, law, trade and commerce and representative of non-shareholders stakeholders, to ensure the stable system of corporate governance in which corporate agents should fully comply with the contractual obligations to protect the stakeholders’ interests.

5. Conclusion

The Islamic principles of corporate governance determine the three dimensions of decision-making: a) by whom; with mutual consultation of Shura or Consultative Council, b) For whom; the ultimate aim of any corporate activity is to gain grace of Almighty Allah and the decision makers on the earth regarded as trustees of the given powers to take decisions in the best interests of His people and c) with whom and to who; the corporate governance decisions require an effective religious supervision to ensure the conformity of all operations and procedures to the Shari’ah. \(^{38}\) Secondly, the Islamic instructions for Muslims to follow the commands of God as told by Prophet (PBUH), suggested teamwork (Al-Anal Al-Jama’ee) and cooperation with all members while the concept of Ameer (group leader) reflects that team members should follow the command of group leader either he is CEO or Chairman of the board. Thirdly, the life of Prophet (PBUH) set an example to run the business of Islamic State either during war-time or in peace time provides the concept of planning and strategy (Al-takhteet) which might be regarded as a procedure to determine the corporate strategy. \(^{39}\) Lastly, the use of auditing, accountancy, and documentary records of all corporate transaction by good man who possesses credibility might be a source of internal control and risks management as well as financial disclosure and reporting which is a key element of corporate transparency of modern era. The International Accounting standards with some modifications are used in Islamic financial sector. \(^{40}\)

On the other hand, the principles of Western corporate governance focus on corporate transparency, effective monitoring, efficient management, sound system of internal control and risks management through competent board of directors who should be free from conflicts of interests and possess skills and experience to run the corporate affairs in competitive environment. \(^{41}\) They should ensure corporate stability to protect investors’ confidence through transparent reporting and disclosure. The

\(^{32}\) Lewis MK, ‘Islam and Accounting’ Accounting Forum 2001, 25(2) at pp.103-127 and vol.9 No.1 at pp. 5-29

\(^{33}\) Zamir Iqbal and Abbas Mirakhor, ‘Stakeholders Model of Governance in Islamic Economic System’ Islamic Economic Studies 2004, 11(2) 43-63

\(^{34}\) Zamir Iqbal and Abbas Mirakhor, (n. 33) 57

\(^{35}\) Zamir Iqbal and Abbas Mirakhor, (n. 33) 59

\(^{36}\) Zulkifli Hasan, ‘Corporate Governance: Western and Islamic Perspectives’ International Review of Business Research Papers 2009, 5(1) 277-293 at 285-287


\(^{39}\) Mohammed Alsanosi, (n. 38) 358-359

\(^{40}\) Mohammed Alsanosi, (n. 38) 361

\(^{41}\) Mervyn K. Lewis, (n.23) 19-20
comparison of both Islamic and Western systems of corporate governance suggest that the basic theme of corporate governance is not different and both system based on capitalism with some priorities of wealth maximisation for investors and rest of the stakeholders by providing them opportunities to contribute in corporate decision-making by promoting fair, just and honest business dealings. The prevailing concept of stakeholders’ theory in German, French, and Japanese models of corporate governance ensure the participation of non-shareholders stakeholders in corporate decision making which is the essence of Islamic model of corporate governance. However, the principle based British model of corporate governance on the basis of ‘comply or explain’ approach is beneficial for Islamic states to adopt those corporate governance practices which are not contradictory with rules of Sharia. The self-regulatory approach of British model provides flexibility for the adoption and operation of Islamic principles of corporate governance to achieve good governance through alternative practices. The objectives of both systems of corporate governance seem similar and are to establish the sound system of corporate governance through efficient, effective management, corporate reporting and disclosure for long-term corporate stability which should not only be beneficial to investors but to the rest of the stakeholders as well.

Abdussalam Mohmoud Abu-Tapanjeh, (n. 15) 564-565