Islamic Corporate Governance

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Abstract: If governance refers to the relationship between government and its constituents, then corporate governance concerns the corporation and its constituents. This definition then begs the question of who the constituents of a corporation are. While there are many who would argue for the corporation having a broad corporate responsibility mandate, in many conventional conceptions of corporate governance the relationships are confined either to the links between those supplying capital and finance to the firm and its management or, more narrowly still, to the relationship between shareholders and management. By contrast, Islamic corporate governance necessarily has a wide commission, with obligations extending to suppliers, customers, competitors and employees, embracing the spiritual as well as the temporal needs of the Islamic community. Nevertheless, while the mandate is clear, and the ethical underpinnings unequivocal, there are some important challenges in implementing this vision.

I. The Nature of Governance

This paper examines the basic elements of Islamic corporate governance, i.e. corporate governance according to Islamic principles. Despite considerable interest in the topic of corporate governance recently, by organizations such as the Islamic Development Bank (Chapra and Ahmed, 2002) and AAOIFI[1], there is not as yet a unified expression in Arabic to represent the meaning of corporate governance, although in Egypt an official translation has been reached for governance pronounced *hawkama* and accredited by the Egyptian Linguistic Department (Sourial, 2004).

By contrast, the English terminology has clear origins. The word 'governance' comes from the Greek word *kybernan*, meaning to 'steer', 'guide' or 'govern'[2]. At its broadest, governance – the act of governing – refers to the relationship between the governors and the

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governed, such as that between the government and the people, and has at its basis the decision-making powers ceded by individuals to those in authority so that the common interests of society can be served. The ship of state needs a good captain and crew to guide it but it also has to have a clear idea of where it is, where it is going, and how well it is progressing. Governance mechanisms are designed for these ends.

This example brings out the point that governance is essentially about decision-making: by whom, for whom, and with what resources. These three dimensions of decision-making apply irrespective of whether we are governing a nation or governing an organization such as a business enterprise. Nevertheless, just as governance of the nation state is informed by a theoretical model of the ideal state and the proper way to run a country (in Plato's *Republic* monarchy, democracy, oligarchy), so too corporate governance is rooted in the conceptual basis of the firm. Here we distinguish three alternative frameworks, covering the firm as a legal entity, the firm as an economic entity, and the firm as an accounting concept. Each of these concepts produces a perspective on one of the three decision-making aspects.

1.1. The legal view

Decision-making 'by whom' is implicit in the legal notion of the firm. For the lawyer, a firm is either an association of persons, a partnership, a limited partnership or a corporation, as well as several variants attached to each type. But the corporation is distinguished by virtue of the fact that it is assigned a distinct legal personality by the law, whereas a partnership is not. The corporate shareholders own the corporation as a legal entity, but the corporation as the legal body in turn owns the corporate assets. Every corporation has the same contractual rights as an individual under law and is treated as capable of owning real property, entering into contracts, suing and being sued, all in its own name, separate and distinct from its shareholders. There is thus a fundamental difference in legal structure between a firm that is incorporated and one that is not (Iwai, 2002). As we shall see, this feature poses some difficulties for Islamic corporate governance.

Nonetheless, while the corporation has a separate personality under law, it is in reality a mere abstract body, incapable of performing any act except through flesh-and-blood humans. As a consequence, corporate law requires a corporation to have a board of directors as the ultimate holder of power to act in the name of the corporation. The board, in turn, hands over power to a class of specialist managers who act on the board's behalf under the control of the CEO, who is often also the chairman of the board of directors and supported by the executive directors. CEO and managerial control was not always the case. In the United States before 1914, bankers and institutional investors held sway in the boardroom and executives had little real decision-making powers (Hawkins, 1997; Simon, 1998). It was not until the 1950s and 1960s that the 'imperial' CEO emerged. Prior to that time, most companies selected one person as chairman of the board and another, typically younger, executive as president.

Thus the legal position of the incorporated firm is straightforward, and provides for three sets of participants:

(i) shareholders, who supply risk capital under conditions of limited liability;
(ii) directors, who are responsible for the stewardship of the company's resources; and
(iii) employees, especially managers, who conduct the company's operations and manage corporate assets on a day-to-day basis under powers delegated to them by the directors.

Moreover, there is a strict two sequence line of the delegation of authority, running from shareholders to directors to management, which is designed to prevent shareholders from interfering directly in the management of the company.

1.2. The economic view

Decision-making 'for whom' flows from the economic view of the firm, which envisages a firm as a business enterprise in pursuit of profits that then accrue to shareholders as claimants of the residual income from corporate assets. The economic organization replaces a large number of market transactions that would otherwise be

undertaken by individuals (and usually are in a simple economy). As societies and technology grow more complex, the problem of coordination by the price system becomes increasingly difficult and costly, pushing the firm to the forefront as an organizing device. By gathering functions within its corpus, the firm reduces the transactions, cost of negotiating the individual transactions. Instead of numerous separate contractual relations between owners, employees, suppliers, customers, creditors, and governments in order to generate profits, the corporation is able to act as an independent holder of property rights, and to form contractual relations with others. The complex network of contractual relations is greatly simplified, leading to a large reduction of transaction costs for all participants, shielding outside parties from the disruptions posed by internal disputes, illness, death or the entry of new partners or owners.

While efficiency enhancing, the separation that is therefore introduced between ownership and control requires a governance framework to ensure that the decisions of the directors and management are compatible with the interests of those supplying the corporation with economic and financial resources. Since the managers are the ones who, in the name of the corporation, make decisions about the employment of corporate assets and what contracts to undertake, there is the danger that they may mistake the decision-making powers entrusted to them for their own power, which can be exercised at their discretion and for their own benefit rather than in the best interests of the corporation as a whole.

1.3. The accounting view

This leads us, finally, to the question of 'with what' resources and thus the issue of 'to whom' accountability is due for the use of resources. In the accounting view of the firm, the enterprise is viewed as a collection of resources for business activities, and information on those assets and the uses made of them is kept, maintained and reported for the benefit of participants and other parties. As such, the concept clearly pre-dates the development of the joint stock company, and grew out of the commercial necessity to treat a group or association of persons as a single entity for record keeping and continuity of business transactions. This 'mercantile notion of the firm'[3] enabled merchants and their accountants to assign partnerships

and other forms of collective business activity a personality in their books, and allowed financial contributions to become the capital of the firm and maintain this status in the books over time. It facilitated the flow of information to a range of contracting parties and meant that a number of persons (in the legal sense) could be regarded in practice as one individual in the rules of trade[4].

Of course, the informational and accountability function assumed even greater importance when the agglomeration of resources widened beyond a relatively closed circle of partners or traders, and public corporations began to raise vast sums of capital from financial institutions and thousands of small investors. They rely on the accuracy of the information supplied to them, under conditions where the liability of shareholders to repay them is limited to their contributed capital. At the same, the liability of the corporate managers is also limited and restricted to those of 'duty of loyalty' and 'duty of care' – the former requires managers to control corporate assets in the best interests of the corporation, and the latter obliges them to administer corporate assets with reasonable care and skill. While those in charge of economic resources must still give account of their stewardship, the accounting by management would nowadays be described in somewhat different terms, as assisting in the efficient allocation of resources by providing information, either for *ex post* monitoring of performance or for *ex ante* decision-making by those responsible for making investment decisions (Whittington, 1992).

II. Models of Governance

Models of corporate governance can be distinguished in their approach to the three dimensions of decision-making that we have identified as the essence of corporate governance: decision-making 'by whom', 'for whom' and 'with what' resources, the latter governing 'to whom' accountability is due. Our primary concern is with Islamic corporate governance, with the aim of contrasting this framework with the Western approach. It is the latter with which we begin. However, while there is undoubtedly a dominant Western approach to corporate governance, at least in Anglo-Saxon countries, there is not only one model. Thus we consider, first, the 'managed corporation' paradigm and then what may be termed the 'socially responsive' corporation.

2.1. The managed corporation

By whom:

What may be called the ‘managed corporation’ model (Pound, 1995 [2000]) of corporate governance has dominated the American corporate arena for decades, and is a legacy of the rise of large public companies and dispersed shareownership. In the model, managers lead and directors and shareholders follow. Boards and shareholders are kept distant from the corporate decision-making process, and are excluded from strategy formulation and policy setting. Senior managers provide the leadership and make the decisions. The board’s role is to hire top-level managers, monitor their performance, and dismiss them if they perform poorly. Shareholders’ only function is to replace the board members if the corporation does not perform well. There is little attempt to take into account the opinions of outside shareholders. In effect, the role of the governance mechanism is to put the right managers in place, give them room to implement their chosen strategy, and monitor their progress.

For Whom:

Milton Friedman’s (1970:32) well known aphorism ‘the social responsibility of business is to increase its profits’ provides a classic statement of the economic position, although it has been replaced by one that firms should maximize shareholder value. The OECD *Principles of Corporate Governance* emphasize that corporations should be run, first and foremost, in the interest of shareholders (OECD, 1999). It is not surprising that the concept of shareholder value is enshrined as the principle of corporate governance and the yardstick by which management performance should be measured among companies based in the United States, Britain and the Anglo-Saxon countries, and has become more prominent in discussions of corporate governance in Europe and Japan. This trend has been driven in large part by the growth of investor activism and the rise of the institutional investors and fund managers who are themselves subject to performance scorecards and must satisfy individual clients pushing for higher returns. The institutions are happy to see portfolio firms put under equivalent performance tests. For their part, the target companies are given a clear market directive to improve the returns earned on existing capital, to invest in projects that promise to earn

returns above the cost of capital, and to sell assets that are worth more to others (Lewis, 2003b).

With what and to whom:
Accounting can be seen as the process of identifying, measuring and communicating information to permit informed judgements and decisions by users of that information, but in the managed corporation model disclosure is often limited and focused on the needs of the individuals and bodies that control resources (Baydoun and Willett, 2000). In fact, corporate governance issues are typically concentrated on those with a direct financial stake in the corporate entity, and especially those supplying capital and finance to the firm. In the standard paradigm 'corporate governance' is synonomous with 'financial governance'[5]. For example, 'corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment' (Schleifer and Vishny, 1997: 737). Others narrow the topic down to shareholders alone; 'good corporate governance is the stewardship of an enterprise's assets for the benefit of its owners' (Pardy, 1992:15).

2.2. The socially responsive corporation
The governance framework above has not gone unchallenged, and in the alternative Western paradigm of the socially responsive corporation, shareholders and others are encouraged to exert influence over policy, and board members and managers are not discouraged from taking their opinions into account. Such an approach has long been entrenched in some European systems of corporate governance. In Anglo-Saxon countries shareholders are largely confined to the use of 'exit', in terms of Hirschman's (1970) dichotomy between 'exit' and 'voice', but not all market systems inhibit shareholders (and others) from directly influencing management. In Germany, for example, the use of 'voice' is encouraged through the accountability arrangements of the *Aufsichtsrat* (supervisory tier). In the Germanic countries (Germany, Austria, Switzerland, Netherlands), there is a separation of executive and supervisory responsibilities. The executive board encompasses the top-level management team, whereas the supervisory board is composed of outside experts, such as bankers, executives from other

corporations (e.g. interlocking directorships) along with employee-related representatives. There is reliance on the supervisory board for oversight and disciplining of the management as well as for a cooperative conflict resolution between shareholders, managers and employees.

In general, the cornerstone of German corporate culture is 'the concept of the interest of the company as a whole' (Schneider-Lenne, 1992:15). The company is seen as a combination of various groups, the goals of which have to be co-ordinated and do not stop at maximization of the return on investment. Survival, and the long-term interests of employees, customers, suppliers, and the general public have to be taken into consideration. 'This commitment is rooted in the German constitution which says that ownership entails obligations' (Schneider-Lenne, 1992:16).

Even in the 'managed corporation' model that has held sway in the United States, institutions (and the many thousands of individual investors they represent) are no longer passive constituents and have emerged as serious participants in the governance process. Both directors and managers have seen the value of actively seeking the input of institutional shareholders. This interaction can take the form of exchanges of information and analysis, company visits, and special private briefings. (Canella, 1995; Brancato, 1997). These linkages are taken further and given a different emphasis in the 'stakeholder' model (Blair, 1995; Monks and Minow, 1995; Gelauff and den Broeder, 1997). In this framework, corporate governance can be seen as the whole system of rights, processes and controls established internally and externally over the management of a business entity with the objective of protecting the interests of all stakeholders (Lannoo, 1995). Such a system recognizes more diverse groups of 'stakeholders' or 'constituents' than simply management and shareholders, including workers, banks, non-financial companies with close ties to the corporation, local communities and the central government. The systems may be characterized by relatively concentrated shareholding, with cross holding among companies not uncommon. Close family links often add an extra dimension.

Consequently, in this alternative paradigm oversight of decision-making is vested in a wider grouping, and the firm is seen to have obligations which extend beyond the interests of shareholders alone.

The 'triple bottom line' agenda, with its economic, social and environmental dimensions, broadens the picture by emphasizing that the corporation draws on social and environmental resources and has broad citizenship responsibilities to ensure that these are maintained and replenished. 'Sustainability' and 'corporate responsibility' are the watchwords. 'Extended producer responsibility' and 'product stewardship' are concepts that focus on the manufacturer's responsibility for the entire life cycle of products, covering packaging and the life of the product through to end use. Accountability to the community for the use of natural, human and civic resourses involves the preparation of valuations of social capital, human capital, the natural environment and cultural heritage in the form of full cost accounting or environmental accounting. In terms of 'international corporate responsibility' there is organizational awareness of health, safety and industrial standards and the development of social accountability standards (AA 1000, SA 8000), 'responsible indices' (FTSE-4-Good), 'corporate sustainability' rankings (Corporate Monitor), 'corporate governance' quotients (Institutional Shareholder Services), and other voluntary codes (Caux Principles, the Global Sullivan Principles, Keidanren Charter, Global Reporting Initiative guidelines).

III. The Islamic Perspective

The preceding comments make clear that Western approaches to corporate governance are not quite as one-dimensional as many accounts often suggest (Abdul Rahman, 1998; Baydoun and Willett, 2000). Peter Drucker, for one, regards 'shareholder value' to be unduly preoccupied with short-term results and calls for a balance between these and the long-range prosperity and survival of the enterprise (Heller, 2000). Another leading management guru, Charles Handy, speaks of the 'citizen company' operating in an environment in which businesses are communities not properties (Handy, 1999). The various principles of good governance and codes of best practice developed internationally over the last decade[6] can be seen as embodying the notion that best practice is not just about attaining maximum profitability or economic efficiency or fair dealing, but is about endeavouring to make sure that companies are directed and

controlled according to moral standards acceptable to the general community (Gooden, 2001).

Nevertheless, despite these ethical undertones underlying the concept of best practice in governance, there remain three difficulties from an Islamic viewpoint (Haniffa and Hudaib, 2003). First, the ethical foundations of Western business morality stem predominantly from socially derived 'secular humanist' values rather than being based on religious moral authority. As such, the central source of authority and the basis of accountability differ from that of Islam, for which *Sharīʿah* is the guiding force. Second, the basic beliefs and values of Western corporate culture remain rooted in self-interest and, even if modified to some degree, there is no over-arching requirement to take account of wider interests of society. Third, the major theoretical model of corporate governance is based on agency theory rather than stewardship theory (Davis, Schoorman and Donaldson, 1997). Thus the major actors are conceived not as stewards who can be motivated to act in the best interests of the principals in a spirit of partnership for the good of the firm, but as self-interested opportunistic agents who have to be watched over and controlled. This characterization is not one that ought to be appropriate for Muslims.

A defining feature is that Islam commands authority over the totality of a Muslim's being, not accepting any distinction between the sacred and the secular. The New Testament injunction to render unto Caesar the things which are Caesar's, and unto God the things that are God's, has led to a divergence in the West between sacred and secular that is anathema to Islam. In Islam, the realms of God and Caesar are not separate jurisdictions.

Two aspects in particular shape the nature of Islamic corporate governance. One is that Islamic law, the *Sharīʿah* claims sovereignty over all aspects of life, ethical and social, and to encompass criminal as well as civil jurisdiction. The literal meaning of the Arabic word *Sharīʿah* 'the way to the source of life' and, in technical sense, it is now used to refer to a legal system in keeping with the code of behaviour called for by the Holy Qur'ān and the Sunnah (the authentic tradition).[7] Every act of believers must conform with Islamic law and observe ethical standards derived from Islamic principles. These ethical principles define what is true, fair and just, the nature of corporate responsibilities, the priorities to society, along with some

specific governance standards. Second, in addition to providing a set of business ethics, certain Islamic economic and financial principles have a direct impact upon corporate practices and policies. Included here are the institution of *zakāh* (the alms tax), the ban on *ribā* (usury) and the prohibition on speculation, calling for the development of an economic system based on profit and loss sharing.

By whom:

Turning to the three dimensions of decision-making that have served as our frame of reference, the Holy Qur'ān is very clear on the issue of 'by whom'. Consider the following:

> "And consult them on affairs (of moment). Then, when you have taken a decision, put your trust in Allah."(*Āl-ᶜImrān* 3:159)
>
> "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." (*Al-Shūra*, 42:38)

In fact, according to the Presidency of Islamic Researches in the commentary on *Sūrah al-Shūra* 'consultation' is the key word of the *sūrah*, and suggests the ideal way in which a good man should conduct his affairs. The commentary goes on to note that this principle was applied to its fullest extent by the Prophet in his public and private life, and was fully acted upon by the early rulers of Islamic society[8]. The *shūrā* or Consultative Council had its origins in pre-Islamic times where it comprised a council of tribal elders. Originally, it constituted an informal forum of deliberation where decisions were arrived at when facing new problems. During these deliberations, the problems in question were thrown open for general discussion. Members of the council were invited to express their considered personal opinions, and these opinions were thrashed out until a consensus was reached. Islam introduced improvements in accordance with the moral principles enunciated by the Holy Qur'ān (Stork, 1999).

Thus the basic message of *Sūrah al-Shūra*, to 'live true in mutual consultation and forbearance, and rely on Allah', contains the essence of governance from an Islamic perspective. Those who wish to serve

Allah must ensure that their conduct in life is open and determined by mutual consultation between those entitled to a voice, for example, in affairs of business, as between partners or parties interested, and in state affairs as between rulers and ruled. Since the Holy Qur'an clearly mandates that any decision involving more than one party requires access and consultation on the basis of principles of *shūrā*, Islam encourages the participants to work together freely and frankly when arriving at decisions (Shaikh, 1988). Institution of a shuratic decision-making process explains how decision-making in business and other activities can meet Islamic moral values. On the basis of *shūrā*, leaders must encourage others to participate in decision-making. An employee would be expected to contribute his or her knowledge to the formulation and implementation of the organizational vision, and consultative procedures should be applied to all those affected, i.e. shareholders, suppliers, customers, workers and the community (Baydoun *et al.*, 1999).

Mawdūdi argues that there are three reasons behind the *shūratic* decision-making process (Mawdūdi, 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 whose 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.

For whom:

'For whom' is straightforward in Islam because the starting points are from Allah. The ultimate ends of business and economics, indeed any human activity, are to Allah, and the means employed should not deviate in any way from the law of Islam; the *Sharīʿah*. A code of approved social behaviour was developed by the Prophet, and his Companions were later appointed, when the Islamic community expanded in the early days of the Islamic state, to institutionalize,

perpetuate and preserve the codes and ensure compliance with the principles of *Sharīʿah*. Under the early Abbasids (750 CE onwards), the institution of *ḥisba* was established to ensure compliance with the requirements of *Sharīʿah*. An office of local administration, the office of the 'inspector of the market', continued into Islam from Byzantine times (Schacht, 1964). This office was called *ḥisba* and the office-holder *muḥtasib;* its functions were Islamicized by entrusting to the *muḥtasib* the collective obligation in the Holy Qur'ān to 'encourage good and discourage evil', making him responsible for enforcing Islamic behaviour in terms of community affairs and behaviour in the market, such as accuracy and honesty in business dealing. Duties traditionally carried out by the *muḥtasib* include: correct weights and measures, fair trading rules, checking business frauds, auditing illegal contracts, keeping the market free, and preventing hoarding of necessities (Abdul Rahman, 1998).

Ḥisba, like the institution of *shūrā*, is a long-standing tradition of Islamic society that can be seen to represent a core element of Islamic corporate governance. The role of the institution became significant during the expansion of the Islamic state as the number of business and commercial activities expanded, exemplifying the nature and extent of the adoption of an ideal system of sacred law in early Islam. To what extent the office could be revived in its traditional form is problematical. Nevertheless, the institution of *ḥisba* survives in terms of the right of every Muslim, irrespective of the presence or absence of an officially appointed *muḥtasib*, to come forward as a 'private prosecutor' or enforcer of Islamic standards of governance (Schacht, 1964:52).

With what and to whom:

The third plank of the Islamic corporate governance system is the process of religious supervision to guarantee that all of the enterprise's operations, contracts and procedures conform with the Islamic code. To a Muslim, all resources are God-given, and ownership of wealth belongs to God. Individuals are only trustees and it is to God that accountability is ultimately due. The purpose of the religious audit is to assure both insiders and outsiders that God's laws are being followed by the firm in its business dealings. The processes involved in religious supervision are illustrated most clearly in the

case of Islamic financial institutions (Algaoud and Lewis, 1999), but the governance principles operate across the full range of business activities. The functions of the religious auditors, as spelt out in the organization's articles of association, are threefold. First, they give advice to the board and management about the religious acceptability of the firm's contractual arrangements and new product development. Second, they provide an independent report to inform shareholders as to the compliance of management with Islamic principles and to the extent that the business is run Islamically. Third, there is an audit involved with the special alms levy, *zakāh*, to establish that the *zakāh* fund is being correctly assessed and properly administered and distributed.

Because of the adverse consequences for the corporation of a qualified report by the religious auditors, the *Sharīʿah* supervisory system is supported by an internal control system put in place by the organization itself. These systems will flank the internal control system so that the firm will have to make sure that its operations are in line with the state-mandated external regulatory system and the requirements of the external auditors. In fact, the religious supervision process will normally operate on a number of levels, some of which may overlap with the external audit, even though the two are formally separate. In the case of an Islamic bank, for example, there will be consultation between the *Sharīʿah* scholars and the management over product design. There will be perusal of all new contracts. A random sampling method will be adopted for checking old contracts and auditing existing activities. There will be an internal control system operated by the institution, combined with liaison between the scholars and the bank to ensure compliance and put in place awareness amongst staff of *Sharīʿah* obligations. Then the *Sharīʿah* board will oversee the collection of the *zakāh* and its distribution to deserving parties. In these various ways, the religious supervisory process will testify that the articles of association, stipulating that the organization run its business in accordance with Islamic law, are in fact met. Of course, the external auditors must also uphold the articles of association and, since they tend to know obvious *Sharīʿah* breaches, they will require *Sharīʿah* clearance on those transactions before finalisation of the accounts, even though there is no formal interaction between the two audit processes.

IV. Implementing the Vision

Table 1 summarizes the alternative approaches to corporate governance. *Shūrā, ḥisba* and the *Sharīʿah* supervisory process and religious audit establish the basic building blocks of a system of Islamic corporate governance. The type of involvement implicit in *shūratic* decision-making procedures provides a vehicle for ensuring that corporate activities and strategies are fully discussed and that a consensus-seeking consultative process is applied. Directors and senior managers would be expected to listen to the opinions of other executives before making a decision and *shūrā* members would include, as far as possible, representatives of shareholders, employees, suppliers, customers and other interested parties. The institution of *ḥisba* offers a framework of social ethics, relevant to monitor the corporation, with the objective of encouraging the correct ethical behaviour in the wider social context. It also empowers individual

Table 1 Alternative Approaches to Corporate Governance

Decision-making basis	**Managed corporation model**	**Socially responsive corporation**	**Islamic corporate governance**
Legal concept of firm: decision-making by whom?	CEO and senior management	Executive and supervisory processes	*Shūratic* decision-making process: consultation and consensus-seeking
Economic concept of firm: decision-making for whom?	Maximize profits Maximize share-holder value	Stakeholders	Institution of *ḥisba* Role of *muḥtasib*
Accounting concept of firm: decision-making with what resources and to whom is accountability due?	Financial governance by shareholders and suppliers of finance	Corporate responsibility Triple bottom line: economic, social and environmental accountability	*Sharīʿah* supervision process Religious audit

Muslims to act as 'private prosecutors' in the cause of better governance by giving them a platform for social action. The third pillar of the system is the discipline provided by Islamic religious auditing, which is a device to solicit juristic advice, monitor compliance with Islamic precepts and collect *zakāh*. This extra layer of auditing and accountability for resource use ensures that the enterprise operates as an Islamic concern.

But no system of governance, however well conceived, will influence organizational behaviour unless it is embedded in an appropriate ethical or moral climate and the principals involved in decision-making set the pattern in the priorities and attitudes. Ethics in Islam, like everything else Islamic, is deeply rooted in the Holy Qur'ān and *ḥadīth* (Nasr, 2002). Just as Islam regulates and influences all other spheres of life, so too it governs the conduct of business and economics. The distinctive characteristics of Islamic economics are that it is Godly, ethical, humane, and moderate and balanced (Khaliffa, 2003). Business should reflect all of these four characteristics, and be conducted by Muslims in accordance with the requirements of their religion to be fair, honest and just towards others.

Business activity, in consequence, must be broadly inspired and guided by the concepts of *tawḥīd* (oneness and unity of God), *iḥsān* (goodness), and *tawakkal* (trust in God) while regulated, within those boundaries, by a legal framework committed to values such as justice and the ban on *ribā* (interest) and the prohibition of *iḥtikār* (hoarding) and other malpractices. In fact, a large number of Islamic concepts and values define the extent and nature of business activity (Rahman, 1994). There are many positive values such as *iqtisad* (moderation), *ʿadl* (justice), *iḥsān* (kindness par excellence), *amānah* (honesty), *infāq* (spending to meet social obligations), *ṣabr* (patience) and *istislah* (public interest). Similarly there are a number of values which are negative, and thus to be avoided: *ẓulm* (tyranny), *bukhl* (miserliness), *ḥirṣ* (greed), *iktināz* (hoarding of wealth) and *iṣrāf* (extravagance). Economic activity within the positive parameters is *ḥalāl* (allowed and praiseworthy) and within the negative parameters *ḥarām* (prohibited and blameworthy) which has to be moderated. Production and distribution which are regulated by the *ḥalāl – ḥarām* code must adhere to the notion of *ʿadl* (justice). Collectively, these

values and concepts, along with the main injunctions of the Holy Qur'ān, provide a framework for a just business and commercial system[9].

V. Challenges for the System

There are a number of challenges, some conceptual, others practical, for an Islamic system of corporate governance. In all, six aspects are identified here.

First, there are issues posed by Islamic law, and in particular whether the way in which the modern corporation is constructed with its distinct legal personality, is acceptable under Islamic law. The principal question here is to what extent the structure of the legal relationships between the shareholders and the corporation violates certain basic principles of Islamic law. The primary difficulty is the absence in Islamic law of the concept of a corporation[10]. A well developed (if complex) system of Islamic jurisprudence exists covering arrangements such as the limited partnership, *shirkah al-'inān* (where partners contribute capital, property and/or labour, share profits and losses and act as agents for co-partners) and trustee financing *muḍārabah* (whereby one party, the financier [*ṣāḥib al-māl*], entrusts funds to another party, the entrepreneur [*muḍārib*], to undertake an activity or venture). However, there are doubts as to how far the rules developed for these arrangements carry over to the modern corporate entity. The corporation is not an agent of the shareholders, based on *al-wakālah*. Nor are the shareholders sureties for the corporation, based on *kafālah*. It has been argued that the modern joint stock company is basically a variation of the Islamic concept of *muḍārabah,* in which some supply capital and others work and run the business on their behalf (Abdul Rahman, 1998). But the similarity with the *muḍārabah* principle can break down when goods are purchased on credit or as soon as profits emerge and are re-employed in the business[11].

Second, it has been suggested instead that shareholders can be treated under Islamic law as equivalent to creditors in a partnership (Nyazee, 1999). The argument is that the subscription agreement is nothing more than a deposit agreement in return for the receipt of shares which entitles the holders to a share of profits, as is done by

creditors in a partnership. As a special class of creditors, the shareholders have the lowest priority for the satisfaction of their debts and, because of this subordination, they receive in return net profits remaining with the enterprise. The difficulty with this position is that those buying shares are not acquiring some amorphous claim called 'equity' but are investing in individual companies. In terms of the spirit of Islam, and the institution of *shūrā,* all Muslim shareholders are expected to take a personal interest in the management of each of the companies in which their funds are invested (Gambling and Karim, 1991). They cannot be disinterested investors. This obligation in turn inhibits the spread of Islamic mutual funds. To many Muslims, the anonymity of a Western stock exchange offends Islamic notions of the responsible use of wealth. The assumption that investors may not be concerned about the detailed operations of a business in which they have invested money is a source of criticism. Muslim stockholders have a responsibility to acquaint themselves about what is taking place in the organization. The fact that Western accounting assumes that a commercial concern is an entity separate from its owners in no way removes this obligation.

Third, the *muḍārabah* principle has been used extensively by Islamic banks, but from the viewpoint of corporate governance there is the problem of the status of investment account depositors vis-à-vis shareholders (Gooden, 2001; Lewis and Algaoud, 2001: chapter 7). Under the trustee arrangement for investment accounts, depositors act as financier by providing funds, and the bank acts as an entrepreneur by accepting them. Neither the nominal capital value nor a predetermined rate of return on deposits is guaranteed. Depositors effectively become shareholders. However, they are a peculiar sort of shareholder in that they are non-voting shareholders. Normally, someone with shares can express their disappointment with the company's performance either by getting rid of their stock or in some way expressing their concern. Hirschman, we recall, referred to this choice as that between 'exit' and 'voice'. Expressed in these terms, the Islamic depositor *cum* non-voting shareholder has little 'exit' and no 'voice'. If the *shūratīc* principle of Islamic corporate governance is to be implemented in Islamic financial institutions, a governance structure is needed that gives investment account depositors in banks a number of rights, including the capacity to influence the bank's

investment decisions, to access investment performance and be supplied with a continuing flow of information[12].

Fourth, many writers on Islamic accounting requirements (the present writer included) have discussed the general policy and principles of accounting from an Islamic perspective, without examining in what ways Western accounting practices might be adapted to address more fully some specific issues of concern to Muslims. For example, from an Islamic perspective, accounting reporting could be enriched by recording in what categories business inputs and outputs fall according to various *fiqh* categories e.g. *ḥalāl* (allowed), *ḥarām* (forbidden), *mubāḥ* (permissible), *makruh* (reprehensible) etc. Reports could also declare if the core business of the enterprise deals with necessities or conveniences or luxuries since Muslims are encouraged to give priority to the production of essential goods, which satisfy the needs of the majority of the Muslim community. Because Islamic financing principles prohibit interest based (*ribā*) transactions, prohibit the financing of goods and services which contradict the value pattern of Islam (i.e. *ḥarām* activities), and require the avoidance of economic activities involving *maysir* (gambling) and *gharar* (uncertainty), financial reports could declare to what extent financing activities are *Sharīʿah* compatible. Environmental impacts of inputs and outputs should also be identified, the scriptural basis for this emphasis being the reports in *ḥadīth* of actions by the Prophet to protect vegetation and animal life.

Fifth, in many Islamic accounts of corporate governance the Islamic position is contrasted with the most extreme 'self-interested agents' models of corporate governance, operating in what Samuelson calls the 'ruthless economy' with a 'cowered labour force' (Samuelson, 1997:6). In these models, competition and market disciplines force the players into line so that the cult of 'shareholder value' prevails. Such accounts ignore the 'stewardship theory' of corporate governance, the counter-views of management gurus such as Peter Drucker and Charles Handy, the work of corporate reformers such as Margaret Blair and Nell Minow, and the codes and principles of best practice and good governance drawn up in a number of settings. Then there are the diverse approaches to corporate governance at a global level, which offer different perspectives again. Indeed, one study identifies six basic models of corporate governance internationally, of which

one is the Islamic model of corporate governance[13]. Rather than drawing the strongest possible contrast between Islamic principles and what is, in effect, one particular paradigm of Western corporate governance, a potential exists to examine the parallels between the Islamic approach and the 'stakeholder' and 'socially responsive' corporate paradigms. For example, the view of Kay and Silbertson (1995: 90 – 91) that the large public corporation is a 'social institution' and should be governed by 'the concept of trusteeship' to 'sustain the corporation's assets', including 'the skills of its employees, the expectations of customers and suppliers, and the company's reputation in the community', would seem to sit comfortably with Islamic thinking.

Finally, corporate governance cannot be divorced from broader governance issues. Some have drawn attention to the 'sharp practices' of companies such as Enron, the 'misdeeds' of auditing firms such as Arthur Andersen, and what would seem to be an 'immoral core' at the heart of capitalism, contrasted with the moral certainty of Islam with respect to business ethics (Wilson, 2003). However, any claims to a moral high ground must be tempered by the poor record of many Muslim countries in terms of corruption. An earlier article (Iqbal and Lewis, 2002) documented the evidence using the World Bank database. While some OIC countries such as Kuwait, Malaysia, Qatar fall into the highest quartile on the corruption index (indicative of a strong control of corruption), a large number fall into the first and second quartiles (indicating poor control of corruption)[14]. The article goes on to compare the Islamic and Western approaches to corruption, providing in the process the first systematic analysis of corruption in terms of the Islamic intellectual heritage. On this point there can be no misunderstanding: it is documented that *Sharīʿah* unequivocally condemns corruption as a severe threat to the social, economic and ecological balance. Furthermore, there seems little doubt that the widespread existence of corruption and the continuance of corrupt behaviour in the business community would be corrosive and damaging to any attempts to implement a system of Islamic corporate governance.

Undoubtedly, both Islam and the West have something to learn from each other with respect to governance and corruption. The West can benefit from reviving the idea, now largely bypassed, that there is

a significant moral and ethical dimension to reducing corruption, needed to stiffen resolve and foster self-restraint. Equally, most Western researchers consider that corruption is more than a moral issue and, at its core, is a problem of bad governance. Islamic societies can benefit from the practical stratagems and administrative and civil reforms now emphasized in the Western approach – they can benefit, in short, from better governance.

Notes

1. The 2003 edition of the *Accounting, Auditing and Governance Standards for Islamic Financial Institutions* contains four governance standards and two ethics codes (AAOFI, 2003).
2. *The Macquarie Encyclopedic Dictionary*, 1990 traces the etymological roots from the Greek to the Latin *gubernare* and to the Old French *governer*.
3. In Lindley, *Law of Partnership*. See Schamell (1962).
4. In effect, under Islamic law, the accountant assigned a *dhimmah* (personality) to the firm, leading to the creation of a legal capacity or *ahliyyah*. See Nyazee (1999).
5. The expression 'financial governance' describes the relationships between those supplying capital and finance to the firm (shareholders, banks, creditors) and its management. See Lewis (2002).
6. The UK Cadbury Code is a prominent example. For Sir Adrian Cadbury's latest thinking, see Cadbury (2002).
7. Islamic law has been defined as 'a hermeneutic discipline which explores and interprets revelation through tradition', Calder (2002: 981).
8. The Presidency of Islamic Researches, *The Holy Qur'ān,* English translation of the meanings and commentary, Medina, 1413AH, note 4579.
9. See Lewis (2001), which explores the implications of this framework for business ethics and Islamic accounting.
10. Kuran (2003). He argues that this absence has hindered the accumulation of wealth through investment by many people pooling their wealth for productive purposes in large enterprises.
11. The contract of *muḍārabah* is being considered as an ideal contract in terms of modern corporate finance because there is no liability for the worker or managing partner in this contract. However, consider the following contrary view. "As soon as profits emerge and are re-employed in the business, the worker acquires liability as a partner to the extent of his share of the profits re-employed in the business", Nyazee (1999: 275).
12. The same is true of holders of *muḍārabah* investment portfolio accounts with *takāful* (Islamic insurance) companies. See Lewis (2003a).
13. Lewis (1999) examines the Anglo-Saxon model, the Germanic model, the Japanese model, the Latinic model, the Confucian model and the Islamic model.
14. In terms of Transparency International's Corruption Perceptions Index for 2003, the highest ranking OIC countries are Oman (ranked 26), Bahrain (27)

and Qatar (32), while the lowest ranked Muslim countries are Sudan (106), Indonesia (122) and Bangladesh (133). See Global Corruption Report (2004).

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