

## **Development in legal Issues of Corporate Governance in Islamic Finance**

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### **Abstract**

This paper is an attempt to present legal issues of Islamic corporate governance (ICG) in the presence of global financial crises. It presents ICG model and discusses its viability in today's corporate structure. The model is based on institution of *Hisbah* which demands book keeping, disclosure, transparency based on *Shariah* principles of Islamic Finance Ethics.

## 1. Introduction

Although there is currently no unified understanding of ‘corporate governance’ under Islamic financial law, a model of Islamic corporate governance (ICG) may be proposed by reconciling Shariah law objectives with the ‘stakeholder model of corporate governance’. This is viable due to the emphasis Shariah law places on property and Islamic financial contractual rights. Furthermore, such a model is also analogous to the proposed OECD principles emphasizing the mechanism of business ethics, decision making, book keeping and final accounts and adequate disclosure and transparency. This article discusses the concept, framework and structure of ICG and then considers whether such a model is viable in today’s multifaith and multicultural society of 21<sup>st</sup> century and the challenges it might face.

Rest of this paper is organised in the following sections. Next section begins with explaining the brief concept ICG and its implication in Islamic financial industry. Fundamentals of business ethics of ICG are given in section 3 which explains two main unique features of ICG. In section 4, general frame work, decision making process and elaborate on the fundamental institution of *Hisbah* on which the process of ICG is really built in. It elaborates on disclosure process, professional and honest book keeping and the process of complete transparencies for all parties involved in contracts. The structure of ICG model is given in section 5 with a question if this model is applicable in 21<sup>st</sup> century of high tech environment and financial sophistication. A thought full need of an excellent ICG is felt for the Islamic world as a role model for the global financial system to bring human harmony on a global level. The final section contains some concluding remarks.

## 2. The Concept of Islamic Corporate Governance

Despite the rapid growth of Islamic finance and corporations since the mid-1970’s, little is written on corporate governance from an Islamic perspective or “Islamic corporate governance” (ICG).<sup>1</sup> After

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<sup>1</sup> Zulkifli Hasan, “Corporate Governance from Western and Islamic Perspectives”, Conference Paper presented at the Annual London Conference on Money, Economy

World War II, the economic organization and commercial practices were inherited from Western colonial powers and therefore, the Islamic 'legal' system lost its intellectual legacy and scholarship, instead it was left to the masses to interpret according to their own whims.<sup>2</sup> Although there has been some interest in corporate governance by organizations including the Islamic Development Bank and the AAOIFI<sup>3</sup>, there is no unified expression in Arabic of "corporate governance".<sup>4</sup> This is a major issue, especially considering the fact that in midst of the recent financial crisis in the Western world, the small but rapidly growing Islamic financial industry has 'weathered the storm'.<sup>5</sup> While share markets in London and New York have faced loss, the Dow Jones Islamic financial index has risen 4.75 per cent in the recent September quarter and lost a modest 7% in 2007.<sup>6</sup> Therefore, further research and improvement in this rising industry is vital.

Timur Kuran, a leading academic on Islamic economics, states that classical Islamic law did not recognize the concept of 'corporation'.<sup>7</sup> Early Muslims were motivated to develop an organization with indefinite existence due to the huge start up costs of providing social services and the need for having an organization that allowed one to spread the costs over an extensive time frame.<sup>8</sup> Therefore, they came up with the concept of *waqf* or an unincorporated trust. Ibn Battuta, a

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and Management in 3<sup>rd</sup>-4<sup>th</sup> July 2008, Imperial College, South Kensington, United Kingdom, 1

<sup>2</sup> Mervyn Lewis, "Accountability and Islam", Conference Paper presented at Fourth International Conference on Accounting and Finance in Transition Adelaide, April 10-12, 2006, 5

<sup>3</sup> Accounting, Auditing & Governance Standards for Islamic Financial Institutions

<sup>4</sup> Mervyn Lewis, "Accountability and Islam", Conference Paper presented at Fourth International Conference on Accounting and Finance in Transition Adelaide, April 10-12, 2006, 5

<sup>5</sup> Clancy Yeates, *Islamic Finance Rides the Storm*

<<http://business.smh.com.au/business/islamic-finance-rides-the-storm-20081010-4yft.html>> at 27 October, 2008

<sup>6</sup> Ibid.

<sup>7</sup> Timur Kuran, "The Absence of the Corporation in Islamic Law: Origins and Persistence" [2005] 53 *American Journal of Comparative Law*, 785-834, 787

<sup>8</sup> Ibid.

famous Muslim traveller describes the significance of the *waqf* in his accounts, such as the ones that provided drinking water, paving of streets, assistance to travellers, financing of pilgrimages and wedding outfits to impoverished brides.<sup>9</sup> According to Marshall Hodgson, the *waqf* served as a ‘vehicle for financing Islam as a society’.<sup>10</sup> A *waqf* was different from a corporation because the founder of a *waqf* was an individual, it was forever controlled by its founder through directions in the founding deed, and in terms of self-governance, a *waqf*’s rules of operation were predetermined. The instructions were enforced through judges or local custom if the deed was silent on certain issues.<sup>11</sup>

The lack of recognition of a ‘corporation’ in Islam creates several problems; including the fact that the vital difference between a corporation and a partnership is that the former is given a distinct legal personality by law. The fundamental difference between a legal structure that is incorporated and one that is not, is the fact that the corporation is given contractual rights, just like an individual under law. It is capable of owning property, entering contracts, suing and being sued and this is separated from its shareholders.<sup>12</sup> Therefore, while a developed and complex system of Islamic jurisprudence exists covering a *waqf*, limited partnership (*shirkah al-inan*) and trustee financing (*mudarabah*), there are doubts as to how far the rules can be carried over to the modern corporate entity.<sup>13</sup>

An attempt towards creating a form of Islamic corporate governance has been made by various scholars, who argue that while Islam did not officially recognize the concept of corporation governance, the Holy Qur’an (Islamic foundational text) and the Sunnah (the way and manners of the prophet) provide principles and guidelines about how decision-making should take place in an Islamic context.<sup>14</sup> According to *Wolfensohn*, the former president of the

<sup>9</sup> Ibid, 792

<sup>10</sup> Ibid, 792

<sup>11</sup> Ibid, 792

<sup>12</sup> Mervyn K Lewis, “Islamic Corporate Governance,” [2005] 9 (1) *Review of Islamic Economics*, 5-29, 6

<sup>13</sup> Ibid.

<sup>14</sup> Ibid

World Bank, "Corporate governance is about promoting corporate fairness, transparency and accountability."<sup>15</sup> Furthermore, the OECD states that, "Corporate Governance-which can be defined narrowly as the relationship of a company to its shareholders or, more broadly, as its relationship to society".<sup>16</sup> The concept of Islamic corporate governance is no different, except that it uses the 'premise of Islamic socio-scientific epistemology premised on the divine oneness of God'.<sup>17</sup>

### 3. *Business Ethics*

The two unique features of Islamic corporate governance are: Firstly, that it is governed by Islamic law or Shariah (which literally means 'road' or 'path') and governs all aspects of an individual's life. This concept is hard for many Westerners to understand since Christ did not promulgate law like the prophets of the Old Testament but came to break the law in the name of the spirit.<sup>18</sup> Therefore, there came to be a divergence in the West between the sacred and the secular, which does not exist in the Islamic world. In Islam, every act of a Muslim must conform to the Shariah and they must observe the ethical standards as set by Islam. <sup>19</sup>These ethical standards include what is fair and just, nature of corporate responsibilities and standards of governance.

Secondly, one needs to consider the effect that Shariah law and certain Islamic economic and financial principles have on corporate

<sup>15</sup> Abdussalam Mahmoud Abu-Tapanjeh, 'Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles' *Critical Perspectives on Accounting* (2008), 3

<sup>16</sup> Ibid.

<sup>17</sup> Zulkifli Hasan, "Corporate Governance from Western and Islamic Perspectives", Conference Paper presented at the Annual London Conference on Money, Economy and Management in 3<sup>rd</sup>-4<sup>th</sup> July 2008, Imperial College, South Kensington, United Kingdom, 3

<sup>18</sup> Seyyed Hossen Nasr, *The Heart of Islam* (2005), 115

<sup>19</sup> Mervyn K Lewis, "Islamic Corporate Governance," [2005] 9 (1) *Review of Islamic Economics*, 5-29, 14

practices and policies.<sup>20</sup> For example, the institution of *zakah* (the alms tax), ban on *riba* (usury) and prohibitions on speculation, and the development of an economic system based on profit and loss sharing.<sup>21</sup> Therefore, in the context of corporate governance, decision making extends beyond the conventional approach to include obligations that extend beyond shareholders, financiers and management to suppliers, customers, competitors and employees.<sup>22</sup> The spiritual as well as the worldly needs of the Islamic community are met.<sup>23</sup> This means that, unlike other forms of corporate governance, the ultimate goal of Islamic corporate governance is *Maqasid Shari'ah*, which was a term coined by a famous Muslim scholar, called Al- Ghazali, and it refers to the protection of the welfare of people, including their faith, life, intellect, posterity and wealth.<sup>24</sup>

Muslims distinguish Islamic governance by stating that the concept of ethics in Anglo-Saxon models of corporate governance is based on 'secular humanist' values rather than religious authority and therefore, Islam ensures stronger accountability assuming that the participants in the corporation are God-fearing. They also argue that Western corporate culture is based on 'self-interest' and there is not enough focus on the wider needs of society.<sup>25</sup> Finally, they distinguish themselves by arguing that ICG is based on the 'stewardship' theory as opposed to the 'agency theory'. Under ICG, the major actors are

<sup>20</sup> Abdussalam Mahmoud Abu-Tapanjeh, 'Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles' *Critical Perspectives on Accounting* (2008)

<sup>21</sup> Mervyn K Lewis, "Islamic Corporate Governance," [2005] 9 (1) *Review of Islamic Economics*, 5-29, 15

<sup>22</sup> Mervyn Lewis, "Accountability and Islam", Conference Paper presented at Fourth International Conference on Accounting and Finance in Transition Adelaide, April 10-12, 2006

<sup>23</sup> Ibid.

<sup>24</sup> Zulkifli Hasan, "Corporate Governance from Western and Islamic Perspectives", Conference Paper presented at the Annual London Conference on Money, Economy and Management in 3<sup>rd</sup>-4<sup>th</sup> July 2008, Imperial College, South Kensington, United Kingdom, 3

<sup>25</sup> Mervyn K Lewis, "Islamic Corporate Governance," [2005] 9 (1) *Review of Islamic Economics*, 5-29, 14

viewed as stewards who are motivated to act in the spirit of partnership. On the other hand, proponents of ICG argue that the Anglo-Saxon model is based on an 'agency theory' where 'self interest opportunistic agents' have to be watched and controlled.<sup>26</sup>

#### 4. Framework of Islamic Corporate Governance

The question then becomes what the framework of Islamic corporate governance is. The question about governance is essentially about decision making, this can be answered by asking the following questions: *by whom, for whom* and with what resources.<sup>27</sup>

##### *Decision making ('by whom' and 'for whom')*

In the Islamic framework, decision making occurs through *shura* or a 'consultative council' and this council used to comprise of tribal elders during the pre-Islamic and Islamic era. It was a process through which a decision was arrived at after a problem was discussed and members of council expressed their personal opinions until a consensus was reached.<sup>28</sup> It is based on the following two verses of the Quran:

*'And consult them on affairs (of moment). Then, when thou has taken a decision, but thy trust in Allah' (Al-Imran 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-Shura, 42:38)*

In Islam 'Shuratic decision-making process' is seen as an essential trust provided from God and therefore, those engaged in it are expected to engender truthfulness, justice and the 'spirit of consensus-seeking' when engaging in the process.<sup>29</sup> Furthermore, everyone is expected to contribute their knowledge and the procedures apply to all who are affected (shareholders, suppliers, customers, workers and community).<sup>30</sup> The starting point and ultimate end of all business,

<sup>26</sup> Ibid

<sup>27</sup> Ibid, 6

<sup>28</sup> Ibid.

<sup>29</sup> Mervyn K Lewis, "Islamic Corporate Governance," [2005] 9 (1) *Review of Islamic Economics*, 5-29, 16

<sup>30</sup> Ibid.

economics and human activity is God. Thus, everything is done ‘for God’ and the means that are used to achieve good governance can not deviate from the Shariah.

### ***Institution of Hisba***

Historically, under the Abbasids (750CE), an institution was established called the *hisba*, or the ‘inspector of the market’ that was responsible for ensuring that all community affairs and market behaviour was conducted according to Shariah law, ensuring that Islamic ethical standards were maintained. The office holder of the *hisba*, was called the *muhtasib*, whose job it was to “correct weights and measures, fair trading rules, checking business frauds, auditing illegal contracts, keeping the market free, and preventing hoarding of necessities”<sup>31</sup> Traditionally, *hisba* represented a core element of Islamic corporate governance in that society.<sup>32</sup> The institution’s role became significant as businesses and commercial activity in the Islamic society expanded. It is the right of a Muslim that they may get an enforcer, regardless of the presence or absence of a *muhtasib*, so that they may enforce Islamic corporate governance.<sup>33</sup> The issue, however, is whether and to what extent such a system can be revived in its traditional form.<sup>34</sup>

### ***Disclosure and Transparency***

In the Quran, the word *hesab* or ‘account’ is repeated more than eight times and refers to ‘account’ in a generic sense, which is that human beings have an obligation to ‘account’ to God on all matters.<sup>35</sup> Accountability is an essential goal in Islam because the belief is that

<sup>31</sup> Ibid, 17

<sup>32</sup> Abdussalam Mahmoud Abu-Tapanjeh, ‘Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles’ *Critical Perspectives on Accounting* (2008)

<sup>33</sup> Mervyn K Lewis, “Islamic Corporate Governance,” [2005] 9 (1) *Review of Islamic Economics*, 5-29, 17

<sup>34</sup> Ibid.

<sup>35</sup> Mervyn Lewis, “Accountability and Islam”, Conference Paper presented at Fourth International Conference on Accounting and Finance in Transition Adelaide, April 10-12, 2006, 2



resources are provided to an individual from God in the form of a trust.<sup>36</sup> Therefore, since accountability is ultimately towards God, it is vital that disclosure of financial facts and accurate information be available to users so that they can make sound financial decisions.<sup>37</sup> The rationale behind this is that since individuals are accountable to God and God has provided them with resources, God expects them to conduct the economic system in a fair and just way. Accountability in this context means accountability to the community (*umma*) or society. If the purpose behind accounting is to serve public interest, it also follows that the *umma* also has the right to know about the operations and transactions of the organization.<sup>38</sup> The rationale behind adequate disclosure is also that the Quran promotes truth as a vital element of the Islamic ethic and therefore, “disclosure of all necessary for accomplishment of the faithful obligations and the making of economic and business decisions consistent with that ethos is the most important tenet of an Islamic accounting system”.<sup>39</sup> Therefore, it is argued that an ethical Islamic accounting system promotes proper disclosure and transparency in business dealings.<sup>40</sup>

#### ***Book-keeping and final account ('with what resources')***

Several verses of the Quran indicate that transactions in business dealings should be written down in an account to ensure financial transactions are determined according to balanced sheets and any unlawful possession of assets are prohibited.<sup>41</sup> *Maqasid Shari'ah*<sup>42</sup>

<sup>36</sup> Abdussalam Mahmoud Abu-Tapanjeh, ‘Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles’ *Critical Perspectives on Accounting* (2008), 8

<sup>37</sup> Ibid.

<sup>38</sup> Mervyn Lewis, “Accountability and Islam”, Conference Paper presented at Fourth International Conference on Accounting and Finance in Transition Adelaide, April 10-12, 2006, 9

<sup>39</sup> Ibid.

<sup>40</sup> Abdussalam Mahmoud Abu-Tapanjeh, ‘Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles’ *Critical Perspectives on Accounting* (2008), 8

<sup>41</sup> Ibid.

<sup>42</sup> “the protection of the welfare of people, including their faith, life, intellect, posterity and wealth”

prohibits acquiring wealth in unlawful means, which leads to social inequality and social waste.<sup>43</sup>

- “Oh you who believe! When you deal with each other in transactions involving future obligations in fixed period of time, reduce them to writing and let a scribe write down faithfully as between the parties” (2:282)
- “And if you are travelling and cannot find a scribe, then there be a mortgage taken... And do not conceal any evidence for the whoever hides it, surely his heart is sinful” (2:283)

Islam is very clear in terms of the principles regarding how one should undertake financial reporting and accounting practices and emphasizes that it should be based upon the spirit and teachings of Islam. The Islamic belief is that doubt and uncertainty should not exist and that is why all the parties' rights and obligations should be fully documented for verification.<sup>44</sup>

### **Religious Audit**

The third plank of Islamic corporate governance system is the process of religious supervision guaranteeing conformity to the Islamic moral code. A religious audit is essential because it assures that insiders and outsiders are abiding by Islamic law in business dealings.<sup>45</sup> The functions of the religious auditors include:

- I) Providing the board and management advice about religious acceptability of the firm's agreements and developments
- II) Providing an independent report to inform shareholders about whether management is complying with Islamic principles and whether the business is run Islamically

<sup>43</sup> Abdussalam Mahmoud Abu-Tapanjeh, ‘Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles’ *Critical Perspectives on Accounting* (2008), 8

<sup>44</sup> Mervyn Lewis, “Accountability and Islam”, Conference Paper presented at Fourth International Conference on Accounting and Finance in Transition Adelaide, April 10-12, 2006, 10

<sup>45</sup> Mervyn K Lewis, “Islamic Corporate Governance,” [2005] 9 (1) *Review of Islamic Economics*, 5-29, 17

III) An audit regarding *zakah* or the special alms levy- to establish that the fund is properly administered and distributed

There is also a system inside the organization itself, ensuring that the operations of the firm are in line with the reports given by requirements of external auditors and the state-mandated regulatory system.<sup>46</sup>

### 5. Structure of Islamic Corporate Governance

According to Zamir Iqbal<sup>47</sup> and Abbas Mirakhor<sup>48</sup>, the structure of Islamic corporate governance closely resembles the stakeholder model of corporate governance.<sup>49</sup> Other academics such as Zulkifli Hasan, Chapra M.U. and Ahmed, H<sup>50</sup> also emphasize the notion of equality in protecting the rights of stakeholders regardless of whether they hold equity.<sup>51</sup>

The objective of firms in the stakeholder model of corporate governance is to maximise the welfare of all stakeholders and this is consistent with Shariah's emphasis on principles of property rights, the contractual framework and its goal of achieving a just social order.<sup>52</sup> According to the shareholder model of corporate governance:

- I) Shareholders should have control
- II) The managers have a fiduciary duty to serve the shareholder interests alone

<sup>46</sup> Ibid, 18

<sup>47</sup> Senior Information Officer at the World Bank

<sup>48</sup> Executive Director of the International Monetary Fund

<sup>49</sup> Zamir Iqbal and Abbas Mirakhor, "Stakeholders Model of Governance in Islamic Economic System" [2004] 11(2) *Islamic Economics Studies*

<sup>50</sup> Chapra, Mu.U. and Ahmed, H. "Corporate Governance in Islamic Financial Institutions" (2002) *Financial Institutions Division, Department of Finance Discussion Paper*

<sup>51</sup> Zulkifli Hasan, "Corporate Governance from Western and Islamic Perspectives", Conference Paper presented at the Annual London Conference on Money, Economy and Management in 3<sup>rd</sup>-4<sup>th</sup> July 2008, Imperial College, South Kensington, United Kingdom, 11

<sup>52</sup> Zamir Iqbal and Abbas Mirakhor, "Stakeholders Model of Governance in Islamic Economic System" [2004] 11(2) *Islamic Economics Studies* 976

III) The objective of the firm is the maximization of shareholders' wealth<sup>53</sup>

Comparatively, Stakeholder theorists reject these propositions and argue that:

- I) All stakeholders should have the right to participate in corporate decisions that affect them
- II) Managers have a fiduciary duty to serve the interests of all stakeholder groups
- III) The objective of the firm is the promotion of all interests (not just those of shareholders).<sup>54</sup>

Supporters of the 'stakeholder theory' argue that shareholders are just one of the numerous groups of stakeholders and therefore, it is important to consider other stakeholders such as the customers, suppliers, employees and local communities.<sup>55</sup> They state that "In the same way that a business owes special and particular duties to its investors...it also has different duties to the various stakeholder groups".<sup>56</sup>

There are two reasons for why ICG closely resembles the stakeholder model: Firstly, the emphasis on 'property rights' in Islam, justifies why stakeholders should be included into decision-making and accountability and this inclusion is based on the following principles of Property law in Islam:<sup>57</sup>

- I) The concept of 'collectivity', meaning that the community, society and state have a right to share the property acquired by individuals or firms

<sup>53</sup> John R Boatright, "What's Wrong- and What's Right- with Stakeholder Management", (2006) XXI (2) *Journal of Private Enterprise*, 109

<sup>54</sup> Zamir Iqbal and Abbas Mirakhor, "Stakeholders Model of Governance in Islamic Economic System" [2004] 11(2) *Islamic Economics Studies*, 964

<sup>55</sup> Joseph Heath, Wayne Norman, "Stakeholder Theory, Corporate governance and Public Management", (2004) 53 *Journal of Business Ethics*, 247-265, 247

<sup>56</sup> Gibson K, "The Moral Basis of Stakeholder Theory" (2000) *Journal of Business Ethics* 26, 245-257, 247

<sup>57</sup> Zamir Iqbal and Abbas Mirakhor, "Stakeholders Model of Governance in Islamic Economic System" [2004] 11(2) *Islamic Economics Studies*, 970

- II) The property of others (including shareholders) can not be harmed or damaged
- III) The rights of others are considered property and subject to the Islamic rules governing the violation of any of those property rights
- IV) Rights are considered property (*al-mal*), therefore, if property is acquired through unlawful means, the property will lose its legitimacy and associated rights<sup>58</sup>

The rights and responsibilities associated with property rights mean that one can not waste, destroy, squander or use the property for purposes that are not permitted by Shariah. Furthermore, wasting and squandering (*israf* and *tabdhir*) are specifically mentioned in Islam and this implies that the firm is expected to preserve the property rights of the wider society as well as those who have participated in the transaction processes of the firm.<sup>59</sup>

Secondly, the emphasis that the Shariah law places on the 'contractual framework' means that every individual, society, corporation and state is bound by the contract which defines the rights and obligations of the parties.<sup>60</sup> This is based on the following Quranic verse: "*O ye who believe, fulfil contracts*" (Chapter 5: Verse 1)<sup>61</sup>. Abiding by contracts is vital for a Muslim because the concept of justice and faithfulness ("*amanah*") exists under Islamic law, which requires that individuals adhere to their contractual obligations in order to prevent betrayal, faithlessness and treachery ("*khiyanah*").

The implication of this in corporate governance is that every stakeholder has a duty to perform contractual obligations according to the terms stipulated in a contract. Under Shariah law, the implicit as well as the explicit obligations under a contract are recognized, which includes a wide spectrum of obligations including the recognition and

<sup>58</sup> Ibid, 971

<sup>59</sup> Ibid.

<sup>60</sup> Zulkifli Hasan, "Corporate Governance from Western and Islamic Perspectives", Conference Paper presented at the Annual London Conference on Money, Economy and Management in 3<sup>rd</sup>-4<sup>th</sup> July 2008, Imperial College, South Kensington, United Kingdom, 12

<sup>61</sup> The Holy Quran, <<http://www.usc.edu/dept/MSA/quran/>> at 23 October, 2008

protection of the property rights of stakeholders, community, society and the state.<sup>62</sup> Broadly speaking, any group or individuals with whom the firm has explicit/implicit contractual obligations may qualify as a stakeholder.<sup>63</sup> This is based on the saying of the Prophet Muhammad, in which he says ‘So give to everyone who possesses a right his right’.<sup>64</sup>

In Arabic, the term ‘right’ is known as *haq* and it refers to something that can be claimed justly and rights are also seen as ‘property’ because they have their beneficial uses and can be possessed. Therefore, it is important under Shariah law to be conscious of the rights of all stakeholders involved.<sup>65</sup>

The duty of shareholders to provide business capital, management to run business, and employees to perform their duties, all arise through a contractual framework.<sup>66</sup> Zulkifli Hassan explains the structure of Islamic corporate governance as based on the ‘stakeholder model’ of corporate governance as shown below.<sup>67</sup>

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<sup>62</sup> Zamir Iqbal and Abbas Mirakhor, “Stakeholders Model of Governance in Islamic Economic System” [2004] 11(2) *Islamic Economics Studies*, 973

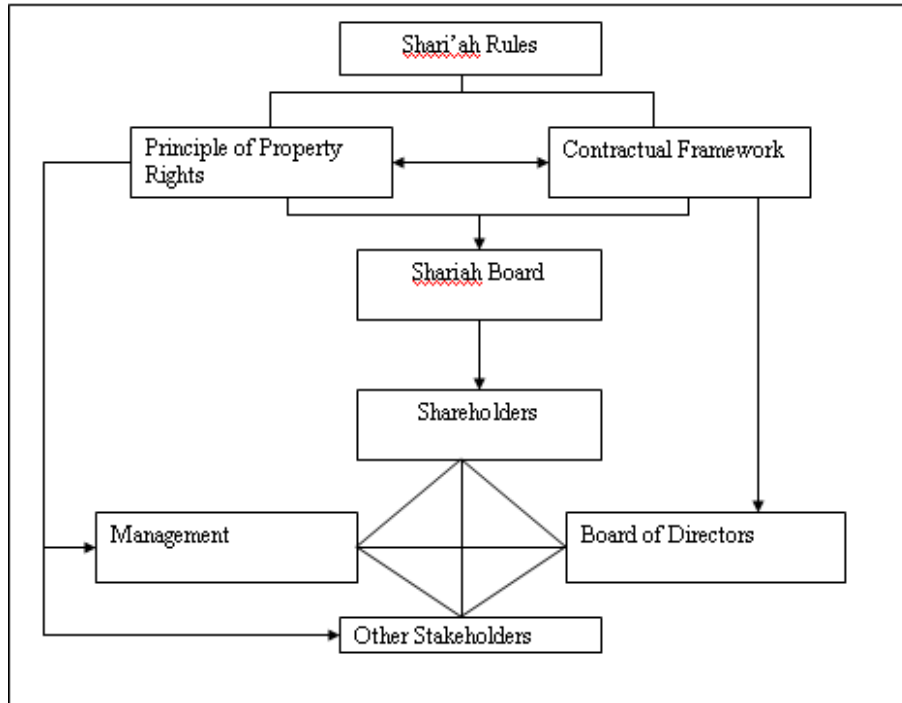
<sup>63</sup> Ibid.

<sup>64</sup> Ibid, 977

<sup>65</sup> Ibid, 977

<sup>66</sup> Zulkifli Hasan, “Corporate Governance from Western and Islamic Perspectives”, Conference Paper presented at the Annual London Conference on Money, Economy and Management in 3<sup>rd</sup>-4<sup>th</sup> July 2008, Imperial College, South Kensington, United Kingdom, 12

<sup>67</sup> Ibid, 13



This model of ICG proposes that it is: 1) based on the principle of property rights and contractual framework, 2) governed by Islamic law or Shariah and 3) all stakeholders are included - the management, shareholders, employees, suppliers, depositors and the community.<sup>68</sup>

According to this model of Islamic corporate governance, the Shariah board advises and supervises the corporation to make sure it abides by Shariah law. The board of directors act on behalf of the shareholders with the duty to monitor and oversee the overall business activities.<sup>69</sup> Also, the managers have the fiduciary duty to manage the firm as a trust for the stakeholders (not the shareholders alone).<sup>70</sup>

<sup>68</sup> Ibid.

<sup>69</sup> Ibid.

<sup>70</sup> Ibid.

### Is this model of ICG a viable one?

According to scholars such as Abu-Tapenjeh, the ICG model achieves the objectives proposed by the global report on corporate governance by the Organization of Economic Co-operation and Development (OECD).<sup>71</sup> The OECD principles were first proposed in May 1999 due the growing awareness of the need for good corporate governance in order to strengthen investor confidence and national economic performance.<sup>72</sup> The OECD principles were also the basis for the report conducted by the World Bank Group about corporate governance.<sup>73</sup> The principles provide specific guidance for policymakers, regulators, and market participants to improve the legal, institutional and regulatory framework underpinning corporate governance. Since being issued in 1999, they have become the international benchmark for corporate governance and form the basis for reform initiatives taken by the government and the private sector.<sup>74</sup> The aim of these principles is to ensure the basis for an effective corporate governance framework including: the rights of shareholders, equitable treatment of shareholders, role of stakeholders in corporate governance, disclosure and transparency and the responsibilities of the board.<sup>75</sup> These principles are based upon four concepts: mechanisms of business ethics, mechanism of decision making, adequate disclosure and transparency, and the mechanism of book keeping and final accounts.<sup>76</sup> As shown above, each of these four concepts can be found in the ICG model.

It is also argued that the ICG framework is consistent with the six OECD principles. The first OECD principle is “Ensuring the basis for

<sup>71</sup> Abdussalam Mahmoud Abu-Tapenjeh, ‘Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles’ *Critical Perspectives on Accounting* (2008)

<sup>72</sup> Organization for Economic Cooperation and Development, <[www.oecd.org/daf/corporate/principles](http://www.oecd.org/daf/corporate/principles)> at 23 October 2008

<sup>73</sup> Ibid.

<sup>74</sup> Ibid.

<sup>75</sup> Ibid.

<sup>76</sup> Abdussalam Mahmoud Abu-Tapenjeh, ‘Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles’ *Critical Perspectives on Accounting* (2008), 10



an effective corporate governance framework”.<sup>77</sup> According to the annotation, this means promoting a transparent and efficient market with rule of law and division of responsibilities. As shown above, under the heading ‘Disclosure and Transparency’, this principle is similar to the ICG model, however, the difference is that the rule of law in ICG must be Shariah, which includes the ban on *riba* (interest) and *ihtikar* (hoarding).

The second principle states that, ‘The corporate governance framework should protect and facilitate the exercise of shareholders’ rights.’ According to ICG, all rights of stakeholders (including shareholders) should be protected due to the emphasis on property rights as described above.<sup>78</sup> However, the difference in ICG is that accountability is to God, not only the shareholders.

The third principle states, “The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.”<sup>79</sup> According to the Islamic concepts of *zakat* (‘special alms levy’), the Shariah board is expected to oversee the collection of *zakat* and its distribution to the relevant parties.<sup>80</sup> This ensures equitable distribution of wealth to all stakeholders and disadvantaged members.<sup>81</sup>

The fourth principle is that the role of stakeholders in corporate governance is to be recognized by creating wealth, jobs and

<sup>77</sup> Organization for Economic Cooperation and Development,  
<[www.oecd.org/daf/corporate/principles](http://www.oecd.org/daf/corporate/principles)

<sup>77</sup> [www.oecd.org/daf/corporate/principles](http://www.oecd.org/daf/corporate/principles)>, at 23 October 2008

<sup>78</sup> Abdussalam Mahmoud Abu-Tapanjeh, ‘Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles’ *Critical Perspectives on Accounting* (2008), 10

<sup>79</sup> Organization for Economic Cooperation and Development,  
<[www.oecd.org/daf/corporate/principles](http://www.oecd.org/daf/corporate/principles)

<sup>79</sup> [www.oecd.org/daf/corporate/principles](http://www.oecd.org/daf/corporate/principles)>, at 23 October 2008

<sup>80</sup> Mervyn K Lewis, “Islamic Corporate Governance,” [2005] 9 (1) *Review of Islamic Economics*, 5-29, 18

<sup>81</sup> Abdussalam Mahmoud Abu-Tapanjeh, ‘Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles’ *Critical Perspectives on Accounting* (2008), 10

sustainability of financially sound enterprises.<sup>82</sup> This is consistent with the following Islamic concepts: *infaq* (spending to meet social obligations), *istislah* (public interest), and the fact that distribution must be regulated by the *halal* (allowed and praiseworthy)- *haram* (prohibited and blameworthy) code.<sup>83</sup> Furthermore, equality is also promoted due to the encouragement in Islam to avoid the following negative values: *bukhl* (miserliness), *hirs* (greed), *ikhtinaz* (hoarding of wealth) and *israf* (extravagance).<sup>84</sup>

The fifth principle, “Disclosure and transparency”, has already been discussed above as Shariah law stipulates that the firm should be accountable to all its stakeholders.

Finally, the last principle states “The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.”<sup>85</sup> Again, the difference here is that the board in ICG is not accountable just to the company, but to God and therefore, must ensure that there is effective compliance with Shariah law. However, due to the concept of *shura* or a ‘consultative council’ as discussed above under ‘decision- making’, it is essential under ICG that the board consults and is accountable to the company and its shareholders.

Following the discussions above, it makes it clear that the model of ICG is consistent with many of the principles proposed by the OECD. However, one crucial difference mentioned by Tapanjeh is that corporate governance in OECD entitles the power of decision making and participation of business dealings to limited people holding a higher designation, such as BOD and senior management.<sup>86</sup> On the other hand, the ICG model provides all related stakeholder models

<sup>82</sup> Ibid.

<sup>83</sup> Mervyn K Lewis, “Islamic Corporate Governance,” [2005] 9 (1) *Review of Islamic Economics*, 5-29, 20

<sup>84</sup> Mervyn K Lewis, “Islamic Corporate Governance,” [2005] 9 (1) *Review of Islamic Economics*, 5-29, 20

<sup>85</sup> Abdussalam Mahmoud Abu-Tapanjeh, ‘Corporate governance from the Islamic Perspective: A comparative analysis with OECD Principles’ *Critical Perspectives on Accounting* (2008), 10

<sup>86</sup> Ibid, 9

with full rights and responsibility to participate in corporate governance.<sup>87</sup>

The issue then becomes whether the ICG model is a viable one. According to academics such as Mervyn Lewis and Timur Kuran, there are various challenges for this model. Kuran argues that the first challenge is the fact until the 19<sup>th</sup> century, the concept of a ‘corporation’ was never recognized under Islamic law and that until quite late, Middle Eastern producers, merchants and investors saw no need for standardized bookkeeping, professional management, or free transferability of shares.<sup>88</sup> Therefore, Islamic corporate governance has developed at a slow pace and one questions, to what extent and how effectively Shariah law and ethics are able to carry over to the ‘modern corporate entity’.<sup>89</sup>

Many also criticize the abovementioned model of ICG by arguing that those that propose it seem to think that ICG is a distinct model of corporate governance. Proponents of ICG distinguish it from Anglo-Saxon models of corporate governance by arguing that the latter has a ‘shareholder value centred’ view of corporate governance and since it does not extend to wide circle of stakeholders, it fails to incorporate their claims, rights and obligations.<sup>90</sup> The proponents of ICG also have a tendency to deem Anglo-Saxon models as extreme ‘self interested’ models of corporate governance operating in a ‘ruthless economy’ where competition and market disciplines force players into line so that ‘shareholder values’ prevail.<sup>91</sup>

On the other hand, they believe that the ICG is based on principles of ethics, morals, and social welfare due to the *Maqasid Shari’ah*<sup>92</sup>. Mervyn argues, however, that such accounts fail to consider other

<sup>87</sup> Ibid, 9

<sup>88</sup> Timur Kuran, “The Absence of the Corporation in Islamic Law: Origins and Persistence” [2005] 53 *American Journal of Comparative Law*, 785-834, 23

<sup>89</sup> Mervyn K Lewis, “Islamic Corporate Governance,” [2005] 9 (1) *Review of Islamic Economics*, 5-29, 21

<sup>90</sup> Zamir Iqbal and Abbas Mirakhor, “Stakeholders Model of Governance in Islamic Economic System” [2004] 11(2) *Islamic Economics Studies* 963

<sup>91</sup> Mervyn K Lewis, “Islamic Corporate Governance,” [2005] 9 (1) *Review of Islamic Economics*, 5-29, 23

<sup>92</sup> Ultimate objectives of Islamic law, which is the protection of the welfare of people, including their faith, life, intellect, posterity and wealth

theories of corporate governance such as the work of corporate reformers such as Margeret Blair and Nell Minow and other diverse approaches to corporate governance at the global level.<sup>93</sup> For example, Peter Ducker is a reformer who argues that ‘shareholder value’ is preoccupied with short-term results and proposes a balance between long-range prosperity and the survival of the enterprise.<sup>94</sup> Another management guru, Charles Handy encourages the ‘citizen company’, which operates in an environment where businesses are seen as communities and not property.<sup>95</sup>

The ‘essentialist critique’ is not just aimed at proponents of the ICG model; it also extends to the supporters of the stakeholder theory. Heath and Norman use the example of Enron to argue in their article that stakeholder theorists undermine the significance of shareholders interests and control in furthering the interests of other stakeholders.<sup>96</sup> They also argue that while stakeholder theorists are all against the classical conception of managerial obligation where, as Milton Friedman quotes, the only ‘social responsibility of business is to maximize profits’, many academics refuse to recognize that the stakeholder theory itself is broken down into several theories relating to corporate social responsibility (CSR).<sup>97</sup> However, this article will not discuss the debate about whether there exists a unified stakeholder theory or whether it consists of several theories. In the end, the main criticism of the ICG model is that while it is consistent with the classic stakeholder theory that promotes corporate social responsibility and also conforms to OECD principles, there is still room for more research in terms of how such a model, based upon classical Islamic thought, can be practically viable in the modern world.

It is important not to separate corporate governance from broader governance issues. Many proponents of ICG seem to claim a moral high ground by arguing that the ICG model is morally certain and

<sup>93</sup> Mervyn K Lewis, “Islamic Corporate Governance,” [2005] 9 (1) *Review of Islamic Economics*, 5-29, 23

<sup>94</sup> Ibid, 13

<sup>95</sup> Handy, C. *The Hungry Spirit* (1999)

<sup>96</sup> Joseph Heath and Wayne Norman, “Stakeholder Theory, Corporate Governance and Public Management”, 53 *Journal of Business Ethics* 247-265, 248

<sup>97</sup> Ibid, 249

ethical, in comparison to the governance structure that have led to the downfall of companies such as Enron or Arthur Anderson.<sup>98</sup> However, to draw such a stark contrast can often ignore the corruption that currently exists in various Muslim countries. Many OIC countries, such as Kuwait, Malaysia and Qatar fall into the highest quartile on the corruption index.<sup>99</sup> Thus, despite the fact that proponents of the ICG discuss how the model of ICG and Shariah law's emphasis on justice and ethics may theoretically condemn corruption, many of these academics fail to discuss how such a model of ICG could be implemented in Muslim communities where corruption is already widespread in the business community.<sup>100</sup>

## 6. Need for good Corporate Governance in the Muslim World

In order for the Islamic market to successfully develop, good corporate governance is necessary and also in accordance with Shariah law principles and the true spirit of Islam. It is important in the Islamic financial sector as well as the corporate sector. The recent rise and growth in Islamic investment and establishment of Islamic corporations, has far outpaced the ability of regulators to establish or agree upon the finalized form of Islamic corporate governance. They need to come up with Islamic corporate governance that is attractive to and consistent with international standards as well as being compliant with Shariah law.<sup>101</sup> Effective Islamic Corporate Governance is consistent with Islamic principles, such as preventing gharar (risk, uncertainty) and unjust business transactions.<sup>102</sup> Good corporate governance encourages “capital formation, creates incentives to engage in value-maximizing behavior, lowers the cost of capital, and fosters strong markets”<sup>103</sup>, but more than that at the heart

<sup>98</sup> Mervyn K Lewis, “Islamic Corporate Governance,” [2005] 9 (1) *Review of Islamic Economics*, 5-29, 24

<sup>99</sup> Ibid.

<sup>100</sup> Ibid.

<sup>101</sup> The Bank of New York Mellon, “Improving Corporate Governance in Islamic Finance” <[http://www.bankofny.com/CpTrust/data/tl\\_islamic\\_finance.pdf](http://www.bankofny.com/CpTrust/data/tl_islamic_finance.pdf)> at 23 October, 2008

<sup>102</sup> Ibid.

<sup>103</sup> Ibid.

of it are structures and processes, which require individuals to exercise their responsibilities with integrity, judgment and transparency, which are all principles central to Shariah law. However, Islamic institutions face various challenges in establishing an effective corporate governance system as it must strictly abide by Shariah law. Nevertheless, a Shariah Supervisory Board is significant for two reasons; firstly, the majority of investors and clients of an Islamic corporation would lose confidence if the management of the bank continued to violate Shariah law. Secondly, the huge emphasis that the Shariah system places on ethics is believed to prevent Muslims from behaving unethically.<sup>104</sup>

## 7. Concluding Remarks

Governance is the relationship that a government has with its constituents. On the other hand, corporate governance refers to the relationship between the corporation and its constituents. The ICG model proposes that the constituents are wider due to the emphasis that Shariah law places on property and contractual rights. This means that while the conventional conception of corporate governance is 'shareholder-centric', the focus in ICG is wider and extends to suppliers, customers, competitors and employers. Thus, it is more in line with the 'stakeholder theory' of corporate governance. Furthermore, the strong focus of Shariah law on ethics, accountability and transparency allows ICG to be consistent with the OECD principles on corporate governance. The Islamic economic system is ultimately based upon maintaining a just and harmonious social order in which the rights of the whole community are protected through the Shariah board, which ensures that the institution adheres to the rules of Shariah law. Theoretically, the concept of ICG is quite stable and in line with various theorists that emphasize corporate social responsibility. A good corporate governance structure is also necessary due to the rise of Islamic institutions. However, one questions whether such a model can be practically implemented in Muslim countries, when most of them are developing or are third world countries that are often ranked high on the corruption index.

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<sup>104</sup> Ibid.

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## تطورات القضايا القانونية لحوكمة الشركات في التمويل الإسلامي

اسحاق بهاتي

كلية القانون والإدارة - جامعة لاتروب

ماريا بهاتي

كلية القانون - جامعة ملبورن

استراليا

### ملخص البحث

تتناول الورقة القضايا القانونية المتعلقة بمراعاة القواعد الإسلامية لحوكمة الشركات في حالة وجود أزمات مالية عالمية، حيث يتم تقديم نموذج لهذا الغرض، ومناقشة جدواه في ضوء البنية المعاصرة لحوكمة الشركات، ويقوم هذا النموذج على قاعدة "الحسبة" التي تتطلب مسك الدفاتر والإفصاح والشفافية وذلك طبقاً لمبادئ الشريعة الإسلامية.

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