

**RESEARCH IN CORPORATE AND  
*SHARI'AH* GOVERNANCE IN THE  
MUSLIM WORLD**

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# **RESEARCH IN CORPORATE AND *SHARI'AH* GOVERNANCE IN THE MUSLIM WORLD: THEORY AND PRACTICE**

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# Preface

Governance issues are of particular concern to Islamic financial institutions as it is crucial that they have appropriate governance structures to assure their clients and other stakeholders that their operations are *shari'ah* compliant. In this context the present study is a welcome addition to the growing literature on *shari'ah* governance, indeed it is the most comprehensive study to date, covering both structural and modelling issues, as well as presenting interesting country studies of *shari'ah* governance in Malaysia, Indonesia, Saudi Arabia, Oman, Bangladesh, Pakistan and Iran. These experiences are especially valuable as they provide a comparative perspective on the implementation of the best practices in Islamic corporate governance.

The relationship between the *shari'ah* board and the board of directors of Islamic financial institutions is a key issue, and much has been learnt from working practices in this area during the last four decades. Practical matters covered include policies for the appointment and retention of *shari'ah* board members. Although this was originally dealt within an informal manner, countries such as Malaysia have introduced detailed legislation to ensure that the best practices have legal foundations. Islamic law, of course, provides a framework for corporate and *shari'ah* governance, but as litigation involving Islamic financial institutions is dealt with under national law, it is helpful if law makers address the challenges that arise in applying commercial law to Islamic financial institutions. The book should be an essential reading for *shari'ah* scholars and those working for law firms dealing with Islamic financial institutions.

A whole part of the work deals with corporate governance from an Islamic audit and accounting perspective. The six chapters covering financial reporting standards for Islamic banks, *takaful* providers and other Islamic financial institutions are of particular value. There is a growing literature on Islamic accounting and auditing but this study, for the first time, has been focussed on corporate governance. Comprehensive financial reporting and detailed data analysis are crucial to ensure that Islamic financial institutions are sound with appropriate transparency for the benefit of shareholders and clients. As a matter of good practice, it is suggested that senior management remuneration should be in the public domain. Voluntary disclosure should be encouraged as a moral imperative and where provision for compulsory disclosure is absent because of inadequate commercial legal provisions.

A major strength of the book is that theory and practice are brought together. Questions that arise include whether Islamic corporate governance

is driven by Islamic teaching, or rather if good practice is evidence based. In other words, there is a debate over whether the approach should be deductive, drawing on Islamic scholarship or inductive, by studying the behaviour of Islamic financial institutions. In reality, the two approaches are not exclusive; indeed, it can be argued they complement each other. The merit of this book is that the approach is multifaceted, with a comprehensive treatment of Islamic corporate governance issues.

***Rodney Wilson***

*Emeritus Professor, Durham University, UK*



## Chapter 1

# Islamic *Shari'ah* and the Principles of Corporate Governance: An Introduction

*Abdurrahman bin Abdulaziz Alaqil*

Financial crises, administrative corruption, and the ensuing economic collapses in most societies have demonstrated the need for a system providing three basic pillars: justice, accountability, and transparency, through which controls and means of control are put into place, ensuring good governance and safeguarding the rights and interests of all parties involved in the firms. It would also limit the uncontrolled behavior of the executive management, and align the role of the board of directors with the objectives of the parties associated with these firms. This system is later known as the “corporate governance.”

In light of this situation, intensive studies in different economies and countries have sought to measure the impact of governance principles and applications in achieving the objectives for which the firm was established, and the extent to which the interests of different parties in firms are taken into account. It observes that good governance practices improve performance and productivity of firms, reduce administrative corruption, and thus enhance economic growth and welfare of the society. A number of studies have considered the issue of corporate governance in Islamic societies, but these were largely preoccupied with the practical aspects and did not link governance system with the values and principles of the early stages of Islamic societies that play a fundamental role in determining its primary objectives.

The economic collapses, financial crises, economic decline, and administrative corruption witnessed by most of the Muslim communities despite their endowments of huge physical and human resources led to the idea of compiling this volume. It aims at surveying the sources of Islamic legislation to examine the extent of the suitability of the contemporary governance applications for Islamic communities as well as their authenticity from the *shari'ah* perspective. This is very important for the Islamic communities because of the vital role Islamic legislations play in shaping the behavior of Muslims which makes these legislations a very influential factor in the proper application of corporate governance.

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## **1.1. The Islamic Perspective of Governance**

### ***1.1.1. Human Nature***

The basic inclination of humans is dominated by injustice and ignorance. Allah (swt) says:

Truly, We did offer Al-Amanah (the trust or moral responsibility or honesty and all the duties which Allah has ordained) to the heavens and the earth, and the mountains, but they declined to bear it and were afraid of it (i.e. afraid of Allah's Torment). But man bore it. Verily, he was unjust (to himself) and ignorant (of its results). (33:72)

This means that the majority of people lack knowledge, and fairness; however, the believer is complemented by learning and justice, which are the origins of virtue, while others remain at the original position of ignorance and injustice. The human being was also described with miserliness and niggardliness.<sup>1</sup> The Prophet (PBUH) says: "Thou could not be a believer until thou love for your brother what thou love for yourself" (Sahih Al-Bukhari). Humans were also natured toward despotism.<sup>2</sup> This despotism becomes more evil with the gaining of more possessions. *Shari'ah* has set rules and regulations that govern human behavior and determine the bases for rights to realize justice among the people.

### ***1.1.2. The Individual and the Group***

A group is, in essence, a number of individuals who are tied together by common interests and objectives. Individuals cannot isolate themselves from their communities and live all alone. Rather, by their very nature, they are destined for participation and communication.<sup>3</sup> The Islamic view toward the individual and the group is a comprehensive and balanced one. It pays attention to the group and individuals in the same way. It neither completely ignores the group as done in capitalism nor does it give importance to the group at the expense of individual as in socialism. Thus, each individual and group has their rights in Islam without any infringement on either party's rights.

### ***1.1.3. Sensing Social Responsibility***

Islam bestows several responsibilities to the individual within the community. Among these are one's responsibility toward oneself, one's family, the community,

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<sup>1</sup>Al-Qur'an (70:21–19).

<sup>2</sup>Al-Qur'an (96: 6.7).

<sup>3</sup>Al-Qur'an (49:13).

and the universe as a whole. The individual is responsible as prescribed by the Islamic *shari'ah*. As the Prophet (PBUH) says:

Surely! everyone of you is a guardian and is responsible for his charges: The Imam (ruler) of the people is a guardian and is responsible for his subjects; a man is the guardian of his family (household) and is responsible for his subjects; a woman is the guardian of her husband's home and of his children and is responsible for them; and the slave of a man is a guardian of his master's property and is responsible for it. Surely, every one of you is a guardian and responsible for his charges. (Sahih Bukhari Vol. 9, Book 89, No. 252)

This responsibility is a great source of benefits in this world and in the hereafter. The responsibility of the community toward individual and the responsibility of the individual toward community are intertwined. Indeed, in this system there is a strong bond among believers, as the Prophet (PBUH) says: "Truly the faithful are to one another like components of a building – each part supports the other" (Muslim and Bukhari); and "the faithful are like a single body: If his eye suffers, then his constitution will suffer; and if he has headache, then his whole system will suffer" (Muslim).

#### ***1.1.4. Keeping the Rights of All Parties***

The Islamic *shari'ah* seeks to preserve all rights that underlie the worldly and religious aspects of people's lives. Thus, one of the *shari'ah's* objectives is to maintain the five necessities, which are: religion, life, mind, offspring, and property. Legislations were made to maintain these five necessities, since life cannot be sustained without any one of them.

A basic tenet of the Islamic *shari'ah* is the sanctity of Muslim's wealth. Allah (swt) says:

O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent. And do not kill yourselves (nor kill one another). Surely, Allah is the Most Merciful to you. (4:29)

The Prophet (PBUH) said: "Your blood and money are impermissible to you."

#### ***1.1.5. Conflict of Interest***

Without divine guidance, human being is self-centered and would infringe on other people's rights and might even take over other people's wealth through illegal ways. This leads to injustice and corruption in the society which would threaten the whole underlying system of the society. Hence, the Islamic *shari'ah* laid down the foundations and regulations which would govern people's relations

and transactions with the target of justice. The Islamic *shari'ah* strives to protect simultaneously public and private interests. However, if there is a conflict between them, then priority goes to the public interest.

### **1.1.6. Efficiency and Work Perfection**

Islam urges for the perfection and articulation of work. The Prophet (PBUH) says: "Allah loves when one of you is doing something that he does it in the most excellent manner" (Al-Qaradawi, 1995); and Allah (swt) says: "And spend in the cause of Allah (i.e., *jihad* of all kinds, etc.) and do not throw yourselves into destruction (by not spending your wealth in the cause of Allah), and do good. Truly, Allah (swt) loves *Al-Muhsinin* (the good-doers)" (2:195).

### **1.1.7. Agent and Client**

Cooperation among members of Islamic society is another teaching of Islam. Allah (swt) says: "Cooperate in righteousness and piety, and do not cooperate in sin and aggression. And fear Allah, indeed Allah is severe in penalty." One aspect of this legitimate cooperation is called agency arrangement. The agency arrangement involves one person authorising another to accomplish a legitimate work for him. Allah (swt) decreed the agent–client law, whereby He allowed the human being to authorize someone to do things on his behalf. Both client and agent must be adult, sensible, and rationale one.

### **1.1.8. Concentration of Wealth/Power**

In most countries, we observe concentration of wealth in the hands of a few rich families. In that way, due to the pressure of family, incompetent family members become managers, or following the status quo governance is deteriorating (Morck & Steier, 2005). However, Islam discourages the concentration of wealth in few hands. The *Qur'an* says:

Whatever spoils from the dwellers of the township Allah has bestowed on His messenger, shall belong to Allah, His messenger, messenger's relatives, and to the orphans, the needy and the travelers in need; so that it may not become the property of the rich among you. Whatever Allah's messenger gives you, take it and from whatever he forbids you, refrain from it. Fear Allah, for Allah is stern in retribution." (59:7)

## **1.2. Islamic Principles of Governance**

As discussed above, Muslims are required to protect and look after their property. To do this, the Islamic jurisprudence provides a framework of financial system based on the core principles of transparency, accountability, and justice. The Islamic jurisprudence also explains the issues related to partnership, contract, and agency that outline corporate governance.

### 1.2.1. Justice

**1.2.1.1. Justice (Adala) in Islam.** *Adala* is derived from *al adal*, which means “straightness”<sup>4</sup>; straightness is contrary to injustice and despotism. Another term related to justice is fairness (*al qist*), which in Arabic means straightness. It means there is no discrimination among the shareholders/investors regarding the position they have in the corporation and the nationality they belong to, and they have the right to question about the dividends and other matters. There is a consensus among the *shari'ah* scholars that without justice the whole system will be spoiled and corrupted. The famous Muslim social scientist Ibn Khaldun says that if people have no trust in the existing system and they assumed that whatever they are earning is not being protected by the existing system, so they will leave their hope and will not participate in the economic activities. In his opinion, this will have a negative impact on the growth and welfare of the economy and consequently there would be big economic and financial chaos in the economy. On the other hand, if they believe that their property and their earnings are protected by the system, then they will strive more for the earnings. This can only be done if justice prevails in the economy.

Allah (swt) says in the *Qur'an*: “Indeed, Allah orders justice and good conduct and giving to relatives and forbids immorality and bad conduct and oppression. He admonishes you that perhaps you will be reminded” (16:90); also, the *Qur'an* says:

So to that [religion of Allah ] invite, [O Muhammad], and remain on a right course as you are commanded and do not follow their inclinations but say, “I have believed in what Allah has revealed of the *Qur'an*, and I have been commanded to do justice among you.” Allah is our Lord and your Lord. For us are our deeds, and for you your deeds. There is no [need for] argument between us and you. Allah will bring us together, and to Him is the [final] destination. (42:15)

And

Indeed, Allah commands you to render trusts to whom they are due and when you judge between people to judge with justice. Excellent is that which Allah instructs you. Indeed, Allah is ever Hearing and Seeing. (4:58)

In the above verses, Allah (swt) ordered that his servants have to play the fair game and hold the justice whatever be the situation. Justice is the main ingredient of governance.<sup>5</sup> There should be no discrimination between friends and

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<sup>4</sup>“*adaltuhu hatta i' tidal*,” which means “I straightened it out and till it became straight and flattened out.”

<sup>5</sup>Al *Qur'an* (4:135), (5:8), (2:282), and (6:52).

enemies, native and foreigners, etc., and similarly it should be prevailed in all the dimensions of life, either it is social, economic, financial, or political. And all the contracts should be based on justice, fairness, and transparency. The Prophet (PBUH) said: “Oh My servants! I forbade on Myself injustice and oppression and I made them forbidden for you, so don’t be unjust towards each other” (Muslim). And Suwaid-bin-Qais reported:

I and the slave Makhrafah brought cloth from Hajr and came there-with to Makkah. Then the Messenger of Allah came to us walking. He bargained with us for cloth and we sold to him. A man there was measuring with weight up. The holy Prophet (PBUH) said to him: Measure and weigh down. (Ahmad, Abu Daud, Tirmizi)

**1.2.1.2. Responsibility of Doing Justice.** From the *shari’ah* point of view, justice is an obligatory duty of all the segments of the society irrespective of individual or group, ruler or subject, master or slave, etc. Everyone is accountable to Allah (swt) and He knows the intentions and actions of every one. This is the duty of the community to cooperate with each other in the good deeds and maintaining the justice among the different agents of the community. Simultaneously, this is the duty of state to train all the agents about justice and righteousness.

**1.2.1.3. The Characteristics of Justice in the Islamic *Shari’ah*.** Under the umbrella of Islam, justice should be without any discrimination or biasness, that is, either someone is Muslim or non-Muslim, male or female, young or old, rich or poor, relative/loves one or not, and enemy or friend. For a judge, parents and kids have no priority. As Allah (swt) says:

O you who have believed, be persistently standing firm in justice, witnesses for Allah, even if it be against yourselves or parents and relatives. Whether one is rich or poor, Allah is more worthy of both. So follow not [personal] inclination, lest you not be just. And if you distort [your testimony] or refuse [to give it], then indeed Allah is ever, with what you do, Acquainted. (4:135)

The Prophet (PBUH) says: “By Allah, if Fatima, the daughter of Muhammad committed theft, Muhammad will cut off her hand!” (Bukhari). In the Islamic context, justice is free of space and time. Thus, he who oppresses in this world and violates, justice will not only be held accountable in this world alone but will also be held accountable hereafter.

## **1.2.2. Transparency in Islam**

**1.2.2.1. The concept of Transparency.** In Arabic, the following words are used for transparency: for example, the word *Al shaff* refers to a curtain which reveals what is behind it. The word *shaffa* means a cloth which is so light and thin that it reveals the body. Whereas *al ifs’ah* is disclosing and revealing and *al wa’duh* is appearing and becoming clear.

**1.2.2.2. Transparency as a Terminology.** Transparency in the language of economics and business is used as follows:

Giving all those concerned an adequate opportunity to become acquainted with and obtain all the relevant information and decisions why the decisions were taken and who are the parties responsible for them and what results followed therefrom.

It is also characterized as the delivery of true, clear, and adequate information to all interested parties in order to give it a chance to analyze corporate operations.

**1.2.2.3. Shari'ah and Transparency Principle.** The principle of transparency, disclosure, and clarity is strongly acknowledged by *shari'ah*, while their opposites, concealment, deception, and misinformation are strictly prohibited. The principle of transparency is the essence of straightness and fairness as we have narrated in verse 135 of chapter *Al Nisa*. The principle of transparency prevailed everywhere in the system of Islam. For example, in administrative or financial matters it has the following points:

1. Full disclosure in making financial reports. (2:282)
2. Credibility in preparing financial reports. (2:283)
3. Full measure and weight. (11: 84–85 and 42:181–83)

The Prophet's (PBUH) sayings also explain in detail the concept of transparency<sup>6</sup> and indicate the importance of transparency in commercial and financial matters.

The above-mentioned verses and sayings of the Prophet (PBUH) show that transparency means clarity, truthfulness, integrity, and comprehensiveness in the information presented by corporate sector to those who are entitled to access the related information. One of the most important tools that enhance the principle of transparency is "financial covenant declaration," which is a prime factor in making information available to the monitoring authorities that check and uphold accountability for transparency.

As explained by Morck and Steier (2005), if investors have trust in the management of the corporations, then they are ready to buy the securities of those

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<sup>6</sup>Abu Huraira narrates that the Prophet (PBUH) passed by a food tray and on dipping his hand into it, he found the food was wet underneath. So he said "Oh! food owner what is this?" The food owner said, "It was rained onto, messenger of Allah." The Prophet said, "Couldn't you put it on top of the food so that people could see it, whoever cheats is not a part of me." The Prophet (PBUH) said, "Three would not be addressed by Allah in the hereafter, nor would he look at them or commend them and they would receive a painful torture: the one whose garment reaches below his heels, the one who keeps reminding people of this good deeds to them and the one who sells his merchandize by constantly swearing that they are worthwhile."

corporations. They also get the assurance that the company will run with honesty, keeping the transparency with the full scale of efficiency. This is the state where corporate governance becomes critical. The corporate governance of large corporations depends on CEOs and other managers. Shareholders are always trying to monitor the level of the governance of these firms.

This would lead to the protection of property, prevent conflict of interest, and limit job exploitation, thus establishing the principle of transparency and clarity on which governance is based.

### **1.2.3. Accountability in Islam**

**1.2.3.1. The Concept of Accountability.** In Arabic, the word *mas'uliah* (accountability) derived from (*su'al*), or question or *sa'ltuhu*, means information which is asked; generally, it is the question about the deeds.

**1.2.3.2. Accountability in Islamic *Shari'ah*.** Accountability is a necessary element of all the deeds and actions. If any action has no accountability, it means that action has no negative or positive value. *Shari'ah* has clearly mentioned about the accountability and its procedure. According to *shari'ah*, accountability is twofold.

**1.2.3.3. Ex Ante Accountability.** There is a clear-cut warning against dishonesty, extravagancy, and waste of money, urging for conservation of expenditure. Allah (swt) says: "And give to the kindred his due and to the poor and to the wayfarer. But spend not wastefully (your wealth) in the manner of a spendthrift." (9:60)<sup>7</sup>

**1.2.3.4. Ex Post Accountability.** An example of this is what was narrated by Abu Humaid Alsaidi, who said the following:

The Prophet (PBUH) appointed a man called Ibn Allutaiba and put him in charge of the charities (*sadaqat*) of Banu Saleem. When he came to settle accounts, he said (to the Prophet), "This is what is due to you and this is a present (to me)." The Prophet said: "Would you sit in the home of your father and mother until your present comes over to you if you are truthful." Then he made a speech to us and after thanking Allah and praising him, he said: "I would appoint a man from among you to do some of the work that Allah has placed under my authority." Then he comes along and says, "This is what is due to you and this is a present that was given to me. Why wouldn't he sit in the home of his father and mother so that his present reaches him? In the name of Allah, if any of you takes something unrighteously, he will meet Allah carrying it in the Day of Judgment. I would recognize one of you who met Allah carrying a camel that keeps grunting or a cow that keeps bellowing or a goat that keeps bleating." Then he raised his hand up high and said: "Oh Allah, have I delivered (the message), my eye saw (it) and my ear heard (it)." (Sahih Bukhari Vol. 9, Book 89, No. 305)

<sup>7</sup>Also see Al Qur'an (7:31), (25:67), and (17:26–27, 29)