Applicability of the Islamic Corporate Governance for Shariah Companies in Malaysia

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Abstract

The Islamic Capital Markets (ICM) have become part and parcel of the modern financial system which not only assists in the growth and expansion of the heavily monetized economy but often becomes a very major indicator of the business cycle movements as well as the confidence and the sentiments of the business community and investors. Of late, ICM has also been a very important vehicle to raise the necessary amounts of funds to affect the national savings needed for rapid economic growth. Most of Shariah companies in Malaysia do not implement an Islamic corporate governance system because of the lack of regulations and exposure from regulators as well as low demand from investors. In line with this development, this paper compares the corporate governance concepts in the conventional and the Islamic perspective. The discussion then proposes an Islamic corporate governance system and requirement of Shariah supervisory board for Shariah companies that could ensure that firms are operating according to Islamic principle thus improve the quality of monitoring role in firms listed on FTSE Bursa Malaysia EMAS Shariah Index.

Keywords: corporate governance, Islamic corporate governance, Shariah companies

1. Introduction

The Islamic Capital system (ICM) in Malaysia has developed to be an important and emerging sector of the international financial system. This financial services industry has been emerging when there is rising interest as well as awareness for financing in compliance with Shariah beliefs on an international scale. Moreover, it reflects the growing resources and ability of investors which is applicable for both Muslims and non-Muslim, and later it looks for and purchases the latest products that meet their demands.

According to Khan and Bhatti (2008) indicated that although Islamic banks have been successful in attracting a huge number of clients from the Muslim world, which accounts for over 24% of the entire world's population (more than 1.3 billion), Islamic finance is becoming more and more popular, especially with investors. This fascination began with widespread religious resurrection, in fact in year 2015 many industry players have awareness to offer Shariah-based product and services, for example the new airlines company in Malaysia, Raiyani Air. The development of ICM in Malaysia is a consequence of all these businesses' growth, which demands that all business dealings comply to Islamic values.

In ICM, Shariah enterprises are more prone to embrace and uphold better levels of ethical business behavior in their operations and stakeholder reporting since the marketplace is considered trustworthy by the community. The governing body and upper management need to encourage greater ethical practices and be less inclined to employ revenue management to alter the company's accounting as emphasized by Rahman and his colleagues (2005). A study by Albassam & Ntim (2017) showed businesses with a high quality on the Islamic values exposure list, which suggests an increased dedication to integrating Islamic beliefs throughout how they operate, make optional CG exposures than those that do not.

In the Quran, Surah 4 verse 29 states that: 'Believers do not devour one another's possession wrongfully; rather than that, let there be trading by mutual consent'. According to Quranic scholars, "wrongfully" refers to any activity that is against the truth, and "reciprocal agreement" means that there should be no coercion, scam, or deception in the deal. Shariah-compliant businesses are supposed to keep away from any illegal or unethical behavior that could negatively impact their performance and image.

The need for a study on corporate governance from Islamic perspectives among Shariah companies is important because according to Ali Shah, Butt, & Hasan (2009), in order ensure improved allocation of assets and better outcomes, effective management requires minimum appropriation of company assets by managers or shareholders with authority. Minimizing expenditures on capital can be achieved by financiers and investors choosing to invest in companies with effective governance. Nevertheless, other parties concerned, including customers and workers, would want to work with and be affiliated with such businesses. This is due to the potential that these connections will be more successful, equitable, and persistent than those engaging companies with inadequate governance.

Even though Islamic finance and corporations has been developed rapidly, there are still lack of companies incorporate corporate governance from Islamic perspective or “Islamic corporate governance” (Bhati & Bhatti, 2009). Many academics have attempted to develop an Islamic business governance framework. It argues that although Islam does not legally adopt the idea of corporate responsibility, the rules and regulations regarding making choices in an Islamic setting are found in the Holy Quran and the Sunnah, or the ways and manners of the prophet. Several studies also propose a full-time Sharıah Secretariat and several departments for further enhancement of the Sharıah functions (Alam, Ahmad, Muneeza, Tabash, & Rahman, 2022). Thus, this paper will discuss and proposes an Islamic corporate governance framework which can be adopted by all Shariah companies in Malaysia.

The following section of the paper presents a concept of corporate governance, followed by a detailed discussion of conventional and Islamic corporate governance in Section 2. Subsequently, Section 3 discuss the Islamic corporate governance concept followed by Section 5 on the requirement of Shariah supervisory board. Lastly, Section 6 draws the conclusion highlights the article’s contribution and identifies the study’s limitations.

2. Concept of Corporate Governance

Corporate governance is a system of laws which govern the procedures, practices, and strategies of a firm. In essence, corporate governance involves managing the goals of multiple stakeholders in a business, which include the public, society, investors, management, clients, vendors, and funders. Since it also offers the framework for achieving a company's goals, corporate governance covers almost all aspects of administration, from strategy development and interior auditing to outcomes assessment and public disclosure.

In the field of financial services, achieving better transparency and responsibility is the ultimate goal of company management, which aims to provide equality to partners as well as investors. Nonetheless, Adegbite (2012) stated that there are serious concerns about these institutions' capacity to adequately oversee corporate activity in light of the recent scandals involving businesses. The objective functions of the corporate governance system are described by Scott (2003) as a collection of legislation, rewards, and practices that uphold investors' confidence. Therefore, maximizing the company's economic efficiency is the ultimate purpose of governing the company (Hasan, 2009).

The corporation faces challenges with corporate governance in which there are two main scenarios namely issue of agency or a dispute of interest including people from the corporation, including members of the board of head, executives, or investors, or the expense of activities makes it impossible to resolve an agency problem via a standard connection. (Hart, 1995). These two problems, which require successful remedies, are unquestionably the reason behind the current business governance structures of the Anglo-Saxon, European, and diverse systems. Any system possesses unique characteristics, signifying various organizational setups as well as the different goals of the company.

Corporations have incorporated business ethics in various approaches, for instance, establishing board-level ethical panels, implementing compliance policies and executives, and creating behaviour rules (Hurst, 2004). Unfortunately, these initiatives haven't stopped American and European businesses from acting unethically, which results in bigger disputes involving organizations. As a result, there is greater pressure on governments and businesses in the United States and Europe to offer more organized administration and programs for ethics in order to ensure they are more accountable to the communities where they run (Peasnell et al., 2000; Klein, 2002; Xie et al., 2003).

Fama and Jensen (1983) stated that the committee freedom is crucial for its efficiency in reducing the leadership's impulsive behaviour. The best possible balance between internal and external directors can be maintained by management to foster independence. Furthermore, studies suggests that the external boards' oversight function is essential since, in their absence, the inside leaders are more inclined to use their position to further their own agendas (Morck et al., 1988).

According to Davis (2013), there is a divide between the business's board of directors and senior management. Moreover, in certain situations, governors are not actively participating in the business's policy. In order for governors to function effectively within businesses, they simply do not have sufficient entry to exact, well-timed, and valuable data.

3. Conventional Corporate Governance versus Islamic Corporate Governance

There are not numerous distinctions between the principles of Islamic and traditional corporate management. The term, which still implies a framework for managing corporations with the aim of achieving the corporation's goal of defending the rights and interests of all investors, is still applicable. Moreover, Choudury and Hoque (2004) viewed from an Islamic perspective, it differs from the traditional system as it appears as an instance of a larger theory of making choices that applies the Islamic socio-scientific semantics concept, and this is predicated on the infinite oneness of God.

According to Hassan (2009), the objective of companies to include so called Islamic corporations is to maximize the shareholder value of wealth. In actuality, this idea is comparable to the Anglo-Saxon corporate governance paradigm. This implies that numerous Islamic firms use the Anglo-Saxon style of business governance. Both Islamic and Western governance principles are crucial to achieving the unique aims and objectives of the business. Islam enhances its worth by highlighting the component of Maqasid Al-Shariah that is absent from Western conceptions as identified by Hasan (2009).

According to Imam Al-Ghazali RA, the goals of Islamic law are known as Maqasid Al-Shariah. However, Maqasid is described in words as a purpose or an inspiration, whereas Al-Syariah is referred to as the law that Allah revealed to Muhammad and includes every facet of life, including family structures, economic issues, and how Muslims should live their lives to uphold the common good.

Al-Ghazali further classifies maslahah into three categories which are daruriyat (the essentials), hajiyat (the complementary), and tahsiniyat (the embellishments). Daruriyat is the basic interest that people should have and Al-Ghazali in his book of Ihya Ulum al-Din lists five basic elements which are faith, life, lineage, intellect and property. According to Kamali (2005), these components are crucial for an individual's religious and everyday activities to operate properly, to the point where eliminating them or implosion would result in rebellion and the breakdown of the community's existing order. Therefore, as stated in its goals, safeguarding them reflects the practical means of maintaining the Shari`ah.

While Hajiyat is the complementary interest purposely to promote and protect the basic interest. People are encouraged to move into the second class of interest to remove hardship and severity. However, it is not a threaten to oblige as it will not reduce the basic necessity. For instance, shortening a prayer (rukhsah) is granted by the Shariah for the travellers aim at preventing hardship during their journey.

The third class of interest is tahsiniyyat refers to desire interest intend to attain refinement and perfection in all levels of achievements. Shariah encourages politeness, gentleness and fair dealing which contributes in a good relation among human beings. Figure 1 illustrate the principles of Maqasid Al-Shariah as per discussion.

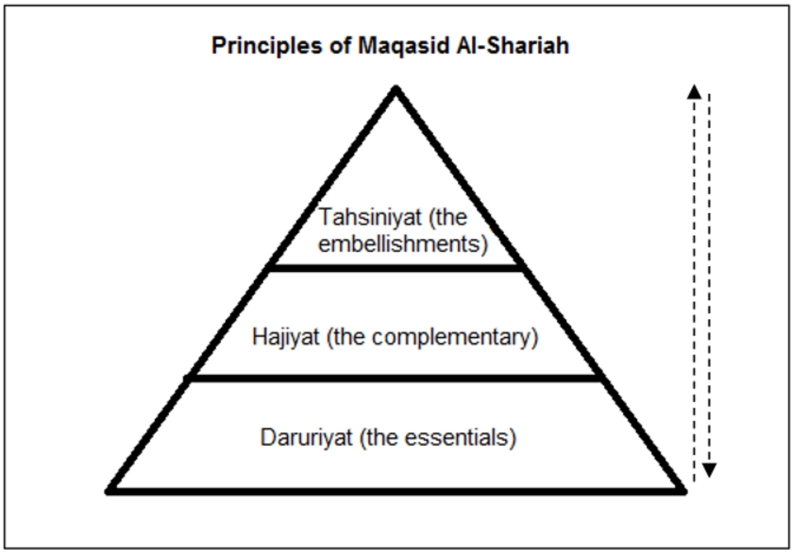

Figure 1. Principle of Maqasid Al-Shariah

The Shariah is generally based on the advantages of oneself and the society, and its regulations are made to safeguard these advantages and make it easier to improve on the circumstances of life for people on Planet. This is conveyed in the Qur'an when it identifies the primary goal of Muhammad's (peace be upon him) prophethood in phrases like: "We have not sent you but a mercy to the world" (21: 107). This may also be noticed in how the Qur'an describes itself, saying that it is "a healing to the (spiritual) ailment of the hearts, guidance and mercy for the believers" (and mankind) (10: 57).

An Islamic corporation's business governance system might be based on an entirely distinct model or an altered version of the Stakeholder-oriented model. The earlier implies to the corporate administration model founded on the concept of consensus where all stakeholders embrace a common aim of Tawhid or the oneness of Allah and the latter is related to adopt partners' value principles with a few adjustments (Choudury and Hoque, 2004).

Even though Tawhid is recognized by all Islamic economists and Muslim legal experts as one of the fundamental principles of Shariah economics, it is noteworthy that not much has been written on the Tawhid cognitive approach to the issue of the governance of companies. Gladly, Choudhury and Hoque (2004) address in their business governance framework the basic Islamic ideology of Tawhid.

The above discussion on objective of Shariah (Maqasid Al-Shariah has significant impact on corporate governance structure since it relates to Muslim employees, managers, companies, customers, and society as a whole.

According to Islam, corporate managers should not depend just on financial incentives or human supervision. They need to be relatively mindful of how their deeds or inactions impact Islamic morals and regulations, as this also affects the rewards they receive in the hereafter. Furthermore, Callen, Morel, and Richardson (2011) dispute, that where there is little external oversight, financial reporting discrepancies are typically less common in areas with powerful values. As mentioned in the Quran:

'.... And act justly. Truly, God loves those who are just' (43:9)

According to this verse, everyone is designated as an administrator, or Khalifah, and given the responsibility of taking care of oneself and others while promoting goodness, fairness, and decent acts. In this regard, Shariah preserves social fairness and welfare and establishes the fundamental guidelines for ethical conduct in politics, society, and the economy (Haniffa and Hudaib, 2002).

Choudhury and Hoque (2004), the goal of business governance in Islam is to establish and achieve an objective criterion by figuring out how important factors interact with each other and how procedures, efforts, and strategic cooperations foster those relationships. Establishing clear and explicit aims helps the development of policies, and diplomacies, and starts through organizational agreement and the application of proper instruments as required by the company. The ultimate purpose of business governance, based on these objective operations, is Maqasid Shari'ah.

4. Islamic Corporate Governance Concept

Rahman (1998) indicated that from Islamic viewpoints, the idea of taklif (responsibilities) entails accepting all obligations, incentives, and duties associated with any kind of property or accountability. This definition states that Man will have lost in his duty, broken his responsibilities, and misunderstood the reason for his existence if he utilizes his will and capacity for objectives apart from those for which they were formed. Malekian and Ali Daryaei (2010) stated that the Islamic concept of corporate governance emphasized three main entities which are transparency, accountability, and trustworthiness. Figure 2 depicts the basic concept Islamic Corporate Governance Concept that should be used by Shariah companies (Saroni, 2008).

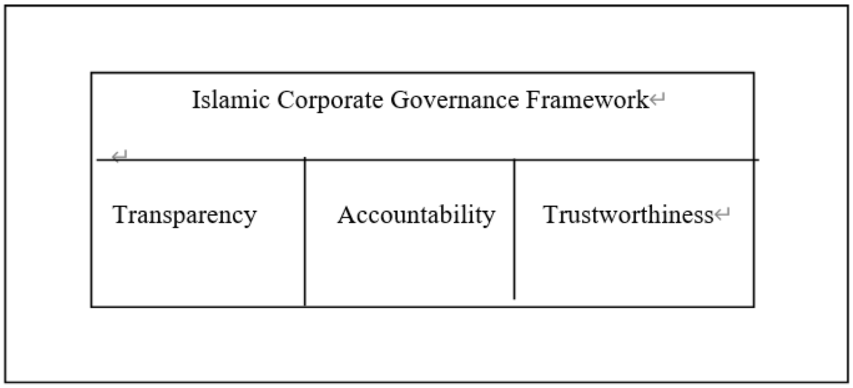

Figure 2. Concept of Islamic Corporate Governance

4.1 Transparency

Transparency is the requirement for openness in all economics decisions (Sekreter, 2012). In Quran, Allah mention "O you who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties…" (Al-Baqarah:282). This verse means every transaction must be in written or recorded to avoid injustice. Thus, in corporate governance framework, a transparency can assist stakeholder to gather true information so reduce corruption and unfairness system.

4.2 Accountability

The word hisab has been repeated more than eight times in many verses in Quran. Hisab or 'account' relates to one obligation to God to all matters relating all human endeavours for which humans are 'accountable' for (Mikailu & Maishanu, 2013). In Islam, Muslims believes that they are accountable to all doings and wrongdoings in this world and hereafter. Muslims also believes that every deed that they are doing must seek Allah redha (pleasure) and must in line with Islamic teaching. Accountability should have in governance to ensure public funds are spent for the specified purposes and according the Shariah law.

4.3 Trustworthiness

The concept of trustworthiness has been stated in Holy Quran in Surah Al-Anfal, verse 27:

'o ye who believe! Betray not the trust of Allah and the Messenger, nor misappropriate knowingly things entrusted to you'

According to this verse, Allah require every individual to convey an ethical conduct especially when dealing with commercial activities. The word Amanah (honesty) incorporates trustworthiness and reliability, thus being trustworthy implies being honest, fair, punctual, and keeping promises and commitment. Leaders should be judged on how they managed and utilized the property given to them at their best abilities. An example was Prophet Muhammad who has been known as Prophethood to be Al Amin (the trustworthy one).

5. Requirement of Shariah Supervisory Board

To improve the Shariah administration process, making choices, transparency, and freedom, Shariah Supervisory Boards (SSB) are crucial in Shariah-compliant businesses. It also describes the most influential Islamic corporate governance resources in Shariah organizations, including the board of directors, also known as the Shariah board. This board is crucial in developing the business's strategy and monitoring management decisions based on the Sunnah of Prophet MOHAMMED (PBUH) and the Holy Quran (Hasan, 2009).

Empirical evidence from a study done by Haniff (2010) founds that indiscretion can be minimized in Sharia based financial system as long as there is a regulation, professional auditors and job security environment. The study conducted by Haniff (2010) showed empirical evidence that suggests the presence of qualified accountants, regulations, and an occupational safety atmosphere can mitigate error in a Sharia-based banking system. While shariah firms are still unaware of the significance of integrating SSB into their enterprises, shariah transparency in financial statements is still in its early stages. It is recommended that Shariah firms should capitalize on this and establish themselves apart from their commercial peers.

Using the vicegerency concept as a foundation, men are considered to be Allah's Khalifah, with three duties: to fulfil Allah's will in improving themselves, the community of humans, and the real life of time as well as space (Al'Mahdi, 2004). Considering SSB's expertise in Islamic law and origins, it is anticipated that it will provide recommendations and guidance on company deals and operations, leading to higher-quality outcomes that are reported.

Grais and Pellegrini (2006) understands that the main responsibilities of SSB include verifying suitable investments through ex-ante Shariah audits, confirming that transactions adhere to the distributing of past Shariah rules, computing and offering Zakat, getting rid of revenues that do not comply with Shariah, and providing advice on how to divide profits and costs to investors and investors. Nonetheless, the way SSBs operate might bring up the following five primary corporate governance concerns: disclosure, expertise, freedom, privacy, and integrity.

Islamic monetary institutions currently have adopted the finest method of designating highly esteemed academics for handling Shariah concerns as described by Alnasser and Muhammed (2012). Since the problems are diverse, they must be tackled by people who are truly skilled and have knowledge of the appropriate fields for the purpose to give insightful responses that identify sources that are trustworthy.

6. Conclusion

This paper compares the corporate governance concepts in the conventional and the Islamic perspective. The main differences are found with regard to theoretical aspects which include concepts of corporate governance, significant players in business management systems and their relationships with other people. The distinction derives from the reality that the Islamic viewpoint perceives business management as a duty committed by Muslims to their God, thereby resulting in the presence and fulfilment of the "implicit" deal with God and the "explicit" commitment with mankind. At the end of the this placed Islam and Allah as the most important roles in corporate management.

This differs from the traditional viewpoint, which emphasizes the real-world ways. There are small distinctions between the two viewpoints in the real world. For corporate ethics to be implemented effectively, the systems and techniques are mostly the same. However, because Islamic businesses must adhere to Islamic rules and manage more complex financial operations, they need comparatively better internal monitoring. Unfortunately, most of the tools are not being practiced yet by Shariah firms in Islamic Capital Market because of less supporting infrastructure and standard by regulators, as well as insufficient human resources are available which explains the limitations. These will constitute the main challenges for Shariah firms in the near future.

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