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The Basic Theory of Corporate Governance in Islamic Perspective

*Ince Nopica
Sanep Ahmad
Abdul Ghafar Ismail
Mohamat Sabri Hassan*

Abstract: *Recent studies that discuss governance in Islamic perspective have been done by various Islamic researcher including Abu-Tapanjeh (2008), Hassan (2009), Haweez (2013), etc. Most this research used the theoretical approach given in conventional corporate governance and provide additional Tahwid concept. The studies in-depth explanation of relationships between governance and Sharia principles (Islamic Law) is very limited therefore this paper tries to discuss and establish the basic theory of corporate governance based on Islamic Law. The approach used in this paper is the concept of human accountability (Amanah) on the mandate given by Allah SWT as Khalifatullah Fill Ardh. This paper expected can explore new approach to explain corporate governance in Islamic perspective.*

Keywords: Corporate Governance, Accountability, Amanah, Khalifatullah Fill Ardh.

Abstrak: *Studi terbaru yang membahas tata kelola dalam perspektif Islam telah dilakukan oleh berbagai peneliti Islam termasuk Abu-Tapanjeh (2008), Hassan (2009), Haweez (2013), dll. Sebagian besar penelitian ini digunakan pendekatan teoritis diberikan dalam tata kelola perusahaan konvensional dan memberikan tambahan konsep Tahwid. Studi mendalam penjelasan hubungan antara pemerintahan dan prinsip-prinsip Syariah (Hukum Islam) sangat terbatas karena tulisan ini mencoba untuk membahas dan menetapkan teori dasar tata kelola perusahaan berdasarkan hukum Islam. Pendekatan yang digunakan dalam makalah ini adalah konsep akuntabilitas manusia (Amanah) dari mandat yang diberikan oleh Allah SWT sebagai Khalifatullah Isi Ardh. Tulisan ini diharapkan dapat mengeksplorasi pendekatan baru untuk menjelaskan tata kelola perusahaan dalam perspektif Islam.*

Kata kunci: Tata Kelola Pemerintahan, Akuntabilitas, Amanah, Khalifatullah Isi Ardh.

INTRODUCTION

Studies of corporate governance based on Islamic perspective have been done by several experts in the field of economics, finance, law, politics and others. Although such studies have tried to give a detailed explanation on the framework of corporate governance in Islamic perspective and the difference with conventional corporate governance, however the basic theory applied in the study is still based on the basic theory of conventional corporate governance. Their studies just commit some customizations and add Syariah principles on fundamental theories that used in conventional corporate governance - especially stakeholder theory - in the establishment of the framework. It has shown that the conventional corporate governance and corporate governance in Islamic perspective does not have significant differences in basic theory. As for what makes it different is the corporate governance in Islamic perspective must comply with the *Sharia* principles (take hold of *Tawhid* concept).

This study tried to discuss and establish the basic theory of corporate governance based Islamic perspective that hold on to al-Quran and Hadist. The basic theory of corporate governance in Islamic perspective that will be established in this study is not using shareholder and stakeholder theory, which is often used in the study of conventional corporate governance and corporate governance in Islamic studies. The approach applied in this study is the concept of human accountability on the trust given by Allah SWT as *Khalifa* on earth (the Islamic perspective).

Furthermore, as is known that one of the principles of good, efficient and effective corporate governance is the principle of accountability other than responsibility, fairness and transparency. This principle is also used in Islamic corporate governance. However, this study will discuss the concept of accountability in different ways which based on *Sharia* approach. The concept of accountability in the Islamic perspective is often described as a form

of accountability on the *Amanah* received. *Amanah* in Muslims life is very important, so as the corporate that receive *Amanah* from someone who has an interest and relationship to the corporate must keep *Amanah* is well. Detailed explanations related to the concept of *Amanah* as a basic of accountability concept will be given on next parts.

The paper is organized as follows. The next section will explain the general descriptions of accountability concept. Section three highlights the Islamic epistemology to support conceptual framework of corporate governance in Islamic perspective. Discussion of accountability as basic theory of corporate governance in Islamic perspective will be shown in section four. Section five concludes the paper.

GENERAL DESCRIPTIONS OF ACCOUNTABILITY CONCEPT IN CORPORATE GOVERNANCE

In *business dictionary online* (2013) (<http://www.businessdictionary.com>.), accountability has defined as the obligation of an individual or organization to account for its activities, accept responsibility for them, and to disclose the results in a transparent manner. It also includes the responsibility for money or other entrusted property. Based on OECD (Organisation for Economic Co-operation and Development : 2002), accountability in the theory and practice of modern management means that managers responsible for carrying out duties or functions are given. Beside that, Managers of corporate must comply with regulations and standards appropriate to their position. The manager of the corporate must report and pay all the actions made by him. He might be given a reward for good performance or bears sanctions due to inadequate performance. In other words, accountability is a relationship based on obligations to present, review, and take responsibility for the performance to be achieved in accordance with the collective agreement and the means used.

The concept of accountability described by Bovens (2007) saw the relationship between the players and the forum, where the players have an obligation to explain and justify their actions. Furthermore, the forum can raise the question and give judgment on the actions of player where the players may be exposed to the effects of their actions. The most important things of the accountability concept that everyone who has relationship with player actions has the right to seek clarification regarding the actions undertaken by the player that entrusted to manage their resources.

Furthermore, Carrasco, Carrington, and Lee (2008) explain that accountability has meaning to ensure: (1) the rules of governance of an organization that shows the attention of member countries, as well as stakeholders, individuals, their communities and non-governmental organizations (NGOs); and (2) the organization is following the rules of governance. The concept of accountability provided by them generally linked with international financial institutions. Based on Stapenhurst (<http://siteresources.worldbank.org>) paper, accountability is a relationship where an individual or body, and the performance of tasks or functions by that individual or body, are subject to another's oversight, direction or request that they provide information or justification for their actions. The accountability involved two distinct stages: (i) answerability; and (ii) enforcement.

Licht (2002) argue that accountability is best understood as a norm of governance, determination a particular mod of holding the reins of power and response to power. Accountability is not a universal norm; however, there is a difference between western countries and non-western countries in preference of democratic accountability. In western concept, the difference of corporate governance paradigm - especially the prevalence of norm conflict of interest between shareholders and stakeholders - is consistent with the priorities value and in accordance with the political theories of corporate governance. This study only provides an explanation of

corporate governance paradigm and accountability concept from western countries.

Accountability concept in corporate governance from western side has generated by agency theory (Jensen and Meckling, 1976). The early formation of this theory is the strict separation between ownership and corporate management. This separation that pose problems because there is differences of interest between shareholders as principals and managers as agents. The concept of accountability based on agency theory can be seen as a duty of the Manager as trustee (the agent) to hold responsible, prepare a report and disclose all activities that become its responsibilities to shareholder who are parties provide the trust (principal).

In the Islamic perspective, manager of corporate must protect the interests of all parties associated with the corporate. The accountability of corporate managers not only to the shareholder, but also to stakeholder. According to Masiyah Kholmi (2012), accountability concept based on agency theory is filled with the selfish, materiality, quantitative nature and constrained by the capitalist system. Selfish and materialistic nature can be seen on manager action within preparing the financial statements. Financial statement is used by managers as a tool to manipulate and accountability in conveying of information (in the form of financial statements) emphasizes the interests of shareholders. The stakeholder interest considered did not provide significant suggestions for the viability of an organization or corporate.

The most important part in the concept of accountability is the party that gives credence have the right to know the policies taken by those entrusted. The form of accountability is not only accountability in the based on financial statements report, but also includes the easiness in obtaining information and management progress either in writing or orally. Implementation of good accountability leans with transparency and keep the trust that has been given to corporate manager.

ISLAMIC EPISTEMOLOGY TO SUPPORT BASIC THEORY OF CORPORATE GOVERNANCE IN ISLAMIC PERSPECTIVE

The main source in explaining Islamic knowledge philosophy (Islamic epistemology) is Al-Quran and Hadist, as described in Al-A'raf 7:52 bellow:

And We had certainly brought them a Book which We detailed by knowledge - as guidance and mercy to a people who believe (<http://www.surah.my/>).

Irkhami (Unknown) argues that epistemology largely determines the character of knowledge, even determine the "rebuttal" anything that should be accepted and what should be rejected. Western epistemology (conventional) has separated religion in science, including the social-economic field. This is discussed more deeply by Irkhami that western epistemology see economics as the science of rational and empirical nature. Everything that can not be proved by the senses, including religious, values and morals do not need to discuss in the economy. Thus science or knowledge is the only valid knowledge. They argue that there is no absolute truth universally applicable; what used to be considered true maybe sometime in the future assessed wrong or vice versa.

Amien book (1983) explain that the philosophy of Islamic knowledge (epistemology Islam) to examine how the knowledge according to Islamic perspective, how its rules, and how people obtain righteousness from Islamic perspective. In a broad sense it can be accepted that Islamic epistemology also discussed problems generally found in conventional epistemology, however specifically Islamic epistemology discuss Al-Quran and Hadith as a source of knowledge. In this book also described that Al-Quran gives infinite resources of knowledge. Al Quran discusses various issues such as

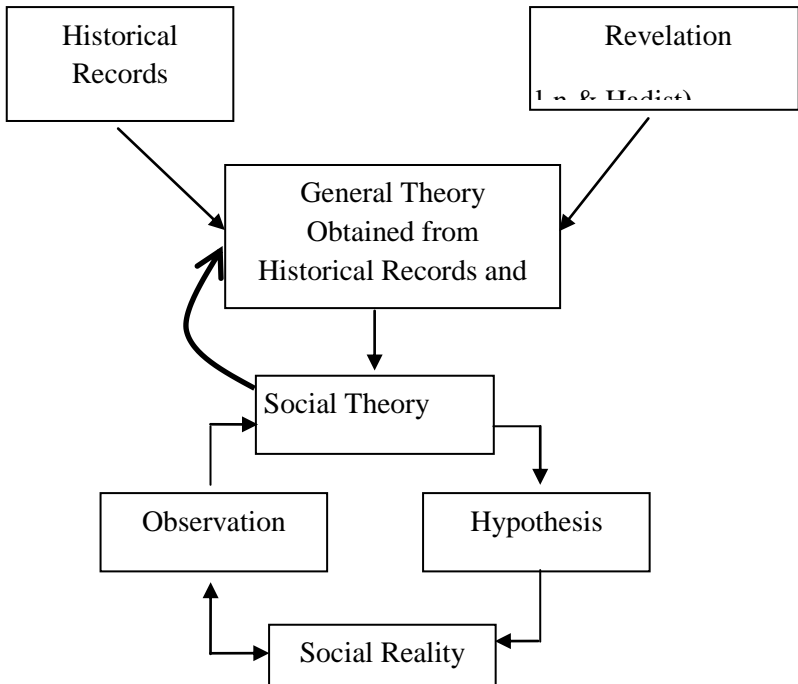
faith, *Sharia* (Worship and Muamalah), morals, attitude, past and future stories, as well as other knowledge by Allah SWT.

In the book of Jusof and Muhammad (2012) discusses the philosophy of Al-Quran by using thematic method (*mawdu'i*) ie determine one topics of knowledge that found in Al-Qur'an. Thematic interpretation method according to Joseph and Muhammad in general consists of two forms, namely:

- i. Selecting one of the available verse in Al-Quran and discuss it thoroughly.
- ii. Selecting a topic or theme and then bring together the verses of Al-Quran related to various topics and themes studied.

The establishment of a new methodology to analyze difficult social problems with combine methods and concepts based on Al-Quran and the Hadith continues to grow. However, the difficulty faced in developing an alternative approach that is based on *Sharia* principles is the exclusion of Al Quran and Hadith in various studies and science. As described by Safi (1996) that the exclusion of Al Quran and Hadith in science studies found only in western science (conventional). It is caused by internal conflicts between scientific communities in the west. In this book, Safi also discusses the basis for recognizing the revelation as a primary scientific knowledge. The model proposed by Safi for textual and contextual analysis can be shown as follows:

Figure 1: Islamic Epistemology Model



Sources: Safi, Louay book (1996)

Figure above shows that the first step in develop social theory is gaining general theory derived with the revelation (Al-Qur'an and Hadith). Henceforth, formalize of hypotheses related to social theories will be studied. The hypothesis that has been formed is then connected with social reality. The social reality is part of observation in getting a social theory.

ACCOUNTABILITY AS BASIC THEORY OF CORPORATE GOVERNANCE IN ISLAMIC PERSPECTIVE

In Islam, life and settling the problems that confronted by human must be based on *Sharia* principles. This requires that human

activities must carry rules set forth in Islam. As Allah SWT said (<http://www.surah.my/7>) :

“Then We put you, [O Muhammad], on an ordained way concerning the matter [of religion]; so follow it and do not follow the inclinations of those who do not know. (Qs Al-Jathiyah 45:18)”

Tafsir of Ibn Kathir explained that this verse gives a warning to Muslims not to take and practice the path or way of life of the Jewish (non-Muslims) people. Allah SWT has determined the direction of life and law in Al-Quran, so follow what has been revealed to them. In this interpretation also explains that there is no God but Him (Allah SWT) and Muslims do not follow those who worship idols. It is not much different with interpretations given by Al-Jalalayn, where he expressed that Muslims must necessarily carried out a religious injunction established by Allah SWT and should not be followed lusts of people who do not know and worship other than Allah.

Furthermore, Human as *Khalifa* on earth given a mandate by Allah SWT should be able to maintaining a predetermined something to them (human). In addition, they also required enforce the laws of Allah SWT on earth and manage what has been mandated(*Amanah*) to them with effective and efficient. *Amanah* value assigned to human is described in the words of Allah SWT as follows:

“Indeed, we offered the Trust to the heavens and the earth and the mountains, and they declined to bear it and feared it; but man [undertook to] bear it. Indeed, he was unjust and ignorant. [It was] so that Allah may punish the hypocrite men and hypocrite women and the men and women who associate others with Him and that Allah may accept repentance from the believing men and believing women. And ever is Allah Forgiving and Merciful. (Qs Al-Ahzab 33:72-73)”

The verse of Al-Quran above clearly states that mandate (*Amanah*) must be borne and fulfilled, it is not to be wasted or neglected, either rejected or denied. As discussed in the verse above, the mandate does not lightly so of the sky, the earth, and the mountains were not able to bear it but for human who want to carry out this mandate, Allah SWT gives forgiveness, blessing, and a great reward to them. Otherwise, when the human deliberately neglect, deny even reject it will receive punishment for their actions.

In Tafsir *Ibn Kathir* also explain that *Ibn Abbas said Al-Amanah* means observance and *Al-Fara'id* (required duty). Allah SWT has offered mandate (*Amanah*) to the sky and the earth and the mountains, where they are able to fulfill it then Allah will give reward, but if it fails to carry out the mandate it will be punished. However, the sky and the earth, and the mountain did not want to receive the mandate (*Amanah*) because it respects the religion of Allah SWT (if they are unable to fulfill the duties) not because of fear of sin. The interpretation given by Al-Jalalayn on this point is also not much different from what is explained by Ibn Kathir where the trust that has been given by Allah SWT is not easy but the human (Adam) has accepted an offer and take on the responsibility. When mandate is filled it will get a reward, but when ignored will get punishment from Allah SWT.

Based on explanation above is obvious that the concept of mandate (*Amanah*) is not easily accepted by human. Mandate (*Amanah*) must be applied in all aspects of life, especially for men who gain mandate (*Amanah*) in performing accountability as *Khalifa* Allah SWT on earth. For a Muslim leader must have *Amanah* character to avoid damage and collapse of the norms and ethics of the society and the state.

Commits its mandate in accordance with Islamic Shari'a is very important matters in Islam. The occurrence of any misappropriation and misuse obligations that recieved by human has shown the absence of *Amanah* character from them (institution or

organization) who receive the mandate. This will cause distrust in people (or institutions or organizations) who received the mandate (*Amanah*). *Amanah* is a basic nature of people, institutions or organizations that are accountable in bear and carry out the mandate received.

Governance exists to ensure that needs and activities of organization or corporate be held efficiently and effectively. Good and efficient corporate performance often associated with good governance. Otherwise when the bad performance of the organization or corporate is bad, its shows poor governance performance. Civil society and regulators asked for accountability and transparency in business is more enhanced.

Accountability in corporate is considered important to ensure the corporate managers have succeeded in achieving the goals set by shareholders and fulfill the interests of the parties associated with the corporate. Manager of corporate in running the company must be accountable not only vertically but also must be responsible horizontally. Accountability vertically in the conventional concept is the accountability of corporate managers to shareholders who has gave mandate to manager. Manager who has received mandate (*Amanah*) from shareholder is required to give accountability, preparing a report and disclose all its activities to the grantor of *Amanah* (the shareholders).

Henceforth, the corporate has responsibility to the consument of their products or to other parties who have interest in the corporation. For consumers, they have the right to obtain goods or services comparable with the money paid to it. Therefore, corporate have obligation for producing goods or services that do not harm the interests of consumers. This shows, indirectly that operational of corporate also should consider consumer interests and other parties who associated with the corporate.

Nowadays, large nnumber of demands to separation between shareholders and managers in corporate management - from both

inside and outside - to get efficient and effective corporate management. The separation of corporate management that become agency problem where managers maximize their their interests and use of corporate funds to achieve these interests. This causes the manager had abused the mandate given to him by the shareholders. Accountability is very important for achieving sustainable corporate performance. Manager accountability must provide corporate performance honestly and transparently to all stakeholders. To achieve this, manager of corporate must be done properly and in accordance with the mandate given by shareholders and stakeholders. In addition, unfavorable to one interest only, but to be fair to all trusts received.

The Panel on Accountability and Corporate Governance in the Voluntary Sector (1999) described that accountability is a claim to explain and accept responsibility in carrying out its mandate (*Amanah*) given. This condition is important because it involves the public trust. Commitment to accountability not only to answer what is desired by outside parties of organization, but also as a tool to build organization expansion, improve management performances, self assessment and strategic planning. In that sense, it is apparent that the nature of accountability of managers would increase the confidence of the public and management performance will be better to get broader mandate (*Amanah*).

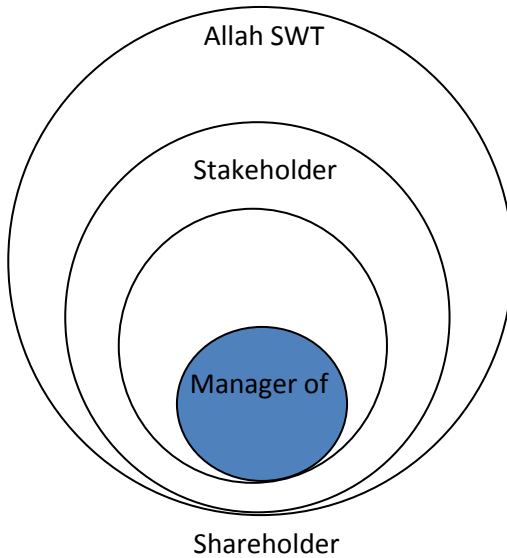
Assurances of implementation of effective and efficient corporate governance provide better protection for the shareholders and stakeholders. In addition, the presence of this regulatory system causes the differences of interest between managers and shareholders can be reduced. The goal of corporate governance in the conventional concept is to get added value and reach the interests of all parties. In general, corporate governance is a concept to improve corporate performance by commit the supervision and control of the activities carried out by managers and ensure accountability of managers to shareholders and stakeholders.

In the Islamic financial institution itself, an increasingly rapid growth has prompted discussion in the implementation of corporate governance based on Islamic perspective (in accordance with *Sharia* principles) among academics and experts in *Sharia* are also increasingly widespread. In the study Chapra and Ahmed (2002) showed that the implementation of corporate governance in Islamic banking is not run efficiently and effectively. Implementation of corporate governance in Islamic banking is closely related to the application of *Sharia* principles in banking activities. The implementation of good corporate governance and compliance with *Sharia* principles will give confidence to all parties.

Chapra and Ahmed (2002) on this study also found that respondents will transfer their funds to the other Islamic bank if it finds the non-compliance with *Sharia* principles. These study respondents from 14 Islamic banks in Bahrain, Bangladesh and Bahrain. This situation shows that the *Sharia* principles in Islamic banking operations have a significant role in influencing the behavior of depositors. Therefore, managers have heavy responsibility in maintaining the mandate and run the bank's operations in accordance with *Sharia* principles.

The executable of mandate given by the client to the Manager will provide a good reputation for Islamic institutions and also increase the confidence of client to the institutions. Maintain and protect the mandate given by the client requires managers to be more careful in carrying out corporate operations so as not clash with the principles of *Sharia*. Manager accountable to *Sharia* compliance in Islamic institutions, not only responsible to shareholders, investors, depositors and the other stakeholders. Further, managers are also responsible to Allah SWT as full owner of the universe. This can be shown by the graph below:

Figure 2. The Islamic Accountability Concept to Corporate Manager



The figure above described a form accountability of corporate manager where the manager in conducting their activities, manager must accountable to shareholders and stakeholders. Further, in carrying out their activities of corporate manager is also accountable to Allah SWT as the owner of the earth and everything in it. Allah SWT knows what is done by humans on Earth and to oversee all human activities i.e in performs its duty, managers can not ignore that Allah SWT also keep an eye on what managers did. As known in Islam, Allah SWT invariably sees what is done by human on earth and records the all activities in this world. This is shown in the following verse of the Qur'an:

- i. *“Have you not considered that Allah knows what is in the heavens and what is on the earth? There is in no private conversation three but that He is the fourth of them, nor are there five but that He is the sixth of them - and no less than that and no more except that He is with them [in knowledge] wherever they are. Then He will inform them of what they*

did, on the Day of Resurrection. Indeed Allah is, of all things, Knowing (QS Al-Mujadilah 58:7).

- ii. *“And We have already created man and know what his soul whispers to him, and We are closer to him than [his] jugular vein. When the two receivers receive, seated on the right and on the left. (QS Qaf 50: 16-17)”*.
- iii. *“That Day, We will seal over their mouths, and their hands will speak to Us, and their feet will testify about what they used to earn. (QS Ya Siin 36: 65)”*.

In the study of Dragomir (2008) have discussed the statement of Jeremy Bentham (1748-1832) which describes that "we monitored the more stringent, the better we behave". According to Dragomir s, this shows that if the management field subject toward publicity then management will behave morally and ethically. In Islamic the concept, the action of manager is not just monitored and supervised by the public but also by Allah SWT. These oblige managers to be more careful in carrying out its mandate and maintain and protect the mandate wisely.

GOVERNMENT ROLES IN ISLAMIC CORPORATE GOVERNANCE

In 1997, the financial crisis that occur in Asian countries caused by weak of regulation and unefficent of corporate governance. The good regulation of corporate governance is required to monitor and control activity of corporate. Furthermore, regulation in Islamic institution must also be provided with *Sharia* based in order to activity of corporate management come off in fair way. The role of government in Islamic corporate governance is more to establish definite rule and *Sharia* based. In preparing the rule or law related to Islamic corporate governance, government should give priority to all parties not just for one party.

The certainty of Islamic corporate governance law will relieve to resolve agency problem because the implementation of Islamic law is very limited and can not be used to resolve agency problems at the present time. The most of countries still apply western law (Civil and Common law) on resolve problem related to Islamic institution. So that, it is very important to have government who is *Amanah*, obey to Islamic Law and act in accordance with *Sharia* principle. In figure 2, the role of government can be shown as stakeholder of corporate.

CONCLUSION

This study discusses the establishment of mandate in the basic theory of corporate governance in accordance with the Islamic perspective. In discuss this, we describes the concept of accountability as a form of accountability over mandate bestowed upon recipients of mandate (*Amanah*). *Amanah* in Islam is very important and relevant to humans as the *Khalifa* of Allah SWT on earth (*Khalifatullah Fill Ardh*). The purpose of this study was to develop and discuss the concept of corporate governance in Islamic perspective based on accountability concept.

This study found that corporate manager, has broad responsibility for their activities. It is not only account to the shareholders and stakeholders, but also to Allah SWT. This is because their duties and responsibilities carried by all of human to show his obedience to Allah SWT as *Khalifa Fill Ardh*. Failure in its performance indicate that it has betrayed the mandate given by Allah SWT as *Khalifa* in eart and will receive punishment for his deeds in this world and hereafter.

Shareholders and managers of corporate are allowed in Islam to improve their welfare or wealth but in effort to maximize their wealth and welfare must be done with halal ways (in accordance with *Sharia* principles). In running it, they should not create any problems or violations against the environment. The study found that in Islam, all stakeholders' interests must be protected from all

the risks that may occur as a result of corporate activities. Therefore, Islam has Maslahah concept which is the fulfillment of human needs based on the priority of human being.

Corporate managers in Islamic concept who earn mandate from both shareholders and stakeholders, in carrying out corporate activities must act in accordance with *Sharia* principles. Fraud in corporate activities and in the delivery of information though it can be done by managers to shareholders and stakeholders, but it will never be able to avoid accountability for acts dishonestly to Allah SWT. By the nature of *Amanah* in manager of Islamic corporate, the conflict of interest between shareholders and managers, as reflected in the agency theory will not happen. In addition, the Manager of Islamic corporate will be more careful in carrying out corporate activities since his actions are big or small, good or bad will be accountable to Allah SWT in this world and hereafter.

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