

# EXPLORATION OF ANTECEDENTS BEHIND ISLAMIC CORPORATE GOVERNANCE: EVIDENCE FROM PAKISTAN

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## ABSTRACT

**Objective:** *Corporate governance contains a set of associations among an organization's management, its board of directors, its stockholders and other stakeholders as well, on the basis of which an organization is organized and focussed. Though, no one knows exactly behind the antecedents of Islamic corporate governance and also no standardized measures for the proficiency of organizations which may bring about the sustainability. The aim of the current study was to explore the antecedents of Islamic corporate governance in Pakistan.*

**Methodology** *Self-developed Semi-structured scale (based on the literature review and the expert's meetings) was castoff later content and context validity to get extensive array of expanded facts.*

**Results** *As per the experts, here are no defined antecedents of Islamic corporate governance, but, organization are working as per some common antecedents. However, the differences lies in the fact that Islamic corporate governance is based on Shariah and the stakeholder's perspective. Moreover, individuals make their decisions based on the information they have.*

**Conclusion** *The most important drivers of Islamic corporate governance are: Structure, Independence, Heterogeneity, Monitoring, Shareholder Activism and Disclosure, and most importantly to have an excellent corporate governance mechanism based on these drivers.*

## INTRODUCTION

Islamic Finance was adopted as a discipline in 1980s, a lot of research began in the said period on Islamic Finance. According to the literature the very first financial company based on Islamic Principles was Mit Ghamr in Egypt. The purpose of the company was to introduce Islamic saving instruments. The characteristics of the savings fund enabled loans for small investors, it was identical to the concept of microlending. The main purpose was to encourage establishment of local business and local wealth maximization. The project was merged into Nasser Social Bank in 1971. The Shariah based financial services were being introduced in Malaysia around the same time. The main purpose was to gratify for the needs of pilgrims to Mecca. The Islamic financial system was further strengthened by establishment of Islamic Development Bank in Jeddah in 1975. Dubai Islamic bank was the first bank of its kind to provide Islamic services privately in United Arab Emirates in 1975. The Islamic Banks adopted pursuit and were established on lines of Dubai Islamic Banks. The initiative of introducing

Interest free Banking was also adopted by conventional banks (Akhtar et al., 2018) because of feasible and efficient corporate governance practices.

Corporate Governance subjects to a formal accountability system of senior managers to shareholders (Abu-Tapanjeh, 2009). However, it is not limited as it also deals with the whole network of formal as well as informal relationships including the corporate sector and with the societal consequences as well (Abbas et al., 2021). It deals with managing and controlling different parties by acting as a corporate constitution and believes in managing together. People must possess similar knowledge level for managing together but that can both be beneficial and problematic for an organization as in high education would lead to easier governance while all of the educated people would want to participate in management (Agarwal et al., 2021). Corporate governance is not only beneficial for the organization but also for the investors as the company gets to generate funds and run its business without having to invest everything on its own while investors can share the profits by investing and not having to do any operational activity. The corporate governance differs in different regions, areas, sectors and companies because each company can't work on the same terms and principles and because the goals of each firm are different (Aggarwal et al., 2019).

The Islamic corporate governance is not eccentric to Islam, therefore, less literature exists on the topic (Adjaoud & Benamar, 2010). The tenants of Islamic Corporate Governance are different from those of conventional Corporate Governance. The Conventional Corporate Governance posits that the corporations are answerable to the shareholders and the stakeholders. The Shariah incorporates a broader accountability concept into conventional corporate governance. The corporations are not only answerable to stakeholders and shareholders but also to Allah Almighty. Thus, this deepens and broadens the concept of corporate governance. Whereby, making the shareholders and stakeholders of the corporation much more secure and confident (Almutairi & Quttainah, 2019).

In Islamic organizations, investor is considered as the business partner according to his share of investment and the profit as well as the risk is shared while in Non- Islamic organizations the business as well as the investors play their part in business activities in order to create wealth (Aluchna & Roszkowska-Menkes, 2019). Corporate governance consists of three major determinants namely accountability, transparency and disclosure. These components must be taken along side by side, if one is not successfully implemented, rest of the determinants would be unable to achieve the targets. In contrast with the conventional corporate governance, where these determinants are owed to the stakeholders and shareholders of the company, the objective of Islamic corporate governance is much refined as these determinants are owed to the Allah Almighty and after that to shareholders and stakeholders. The main purpose of Islamic corporate governance is to run the company by keeping Islamic laws in consideration (Amorelli & GarcíaSánchez, 2020). So, Islamic corporations are in a dire need of a right corporate governance mechanism.

Islamic governance mechanism deals with governing companies in a way that is not in contrast with the Islamic rules and regulations, for example, there must not be any interest incorporated in any business transaction or investment. Money should only be invested in ethical business and not to indulge in any unethical business for wealth generation, the profit as well as risk sharing among the investors, prioritizing the societal wellbeing and taking care of the rights of each and every stakeholder of the company (Asensio-López et al., 2019). So, there arises a need of identification of the factors leading to Islamic corporate governance which would work in the best interest of institutions as well as the environment. This paper aims to identify such

factors as to help institutions and investors. The next section of the paper presents the literature review, after that methodology is presented followed by findings and discussions and the last section concludes the paper.

The current literature does not identify the antecedents of Islamic Corporate Governance, that maybe because Islamic Corporate Governance have not been adopted by Muslim countries as it should have been. Therefore, this study intends to investigate some of the major antecedents of Islamic corporate governance.

## LITERATURE REVIEW

Corporate governance has been introduced recently as it made an appearance in corporate world since last two decades and its concept is already residing in Islam and Muslim world (Ba, 2021). Corporate governance has been explained in many ways but there is not enough literature available on Islamic corporate governance in comparison with the conventional one (Baltrunaite, et al., 2021). Corporate governance can be defined as "*the way in which boards monitor the functioning of a company by its management, and how board members are accountable to shareholders, stakeholders, and the firm*" (Bayrakdaroglu et al., 2012). This definition excludes the notion of BOD's being accountable to God and the community or society, both of which are important aspects of Islamic corporate governance. The notion of corporate governance was endorsed as a result of growing awareness of the importance of protecting all stakeholders' interests, especially minority shareholders'. And it's been claimed that effective corporate governance is greater than just a good idea because it encourages investment flow, supports healthy capital markets and reduces capital costs (Beiner et al., 2006). The broad view is that governance enables an organization to set clear goals and work toward achieving them more efficiently. Similarly, if properly administered, organizations may efficiently fulfil their corporate and budgetary goals and aspirations.

Lazonick & O'Sullivan (2000) stated that there are three primary factors that make up the corporate governance structure: who makes investment decisions in firms, what types of investments they make, and how investment returns are allocated. Corporate executives and managers are familiar with these dimensions of corporate governance, and they are also the concepts that Shari'ah compliant organizations are most concerned with (Bhatia & Gulati, 2021). Because the source of capital, how it is used, and how the return is divided are all important factors in a company's Shari'ah compliance, those in charge of Islamic enterprises must be extremely cautious. Because corporate governance may make or break a company's future. It is critical to implement excellent governance at all levels of the firm or corporation in order to accomplish the organization's various duties and objectives in a transparent and effective manner (Boivie et al., 2021). Apart from the Islamization of the notion, an Islamic corporate governance system achieves these goals as well. Several nations, such as Malaysia, have published Islamic governance standards or recommendations for Islamic Financial Institutions, as well as other organisations or institutions (like AAOIFI and IFSB). However, the difficulty with these regulations or guidelines is that they are not relevant to all Islamic corporations, and they are not binding on the entire world, thus they cannot be uniformly adopted and implemented to all Islamic corporations.

Boyd et al. (2017) stated that because the main point of Islamic corporate governance is to obey Allah, traditional corporate governance frameworks are inadequate for Islamic corporate governance. The following elements must be applied to all Islamic corporations, regardless of geographical locations for better governance.

- 1 Each Islamic corporation must have an independent Shari'ah committee to oversee its activities and management. The Shariah scholars will be in a stronger position to give advice on any questionable behaviours that occur in the company (Campanella et al., 2021).
- 2 The Islamic corporation's style of decision-making should be consultation or Shura and consensus seeking (Elamer et al., 2020).
- 3 The Shari'ah committee should possess sub-committees in all areas of the company, as this will allow the main committee to keep track of everything that is going on in the company (Carter et al., 2010; Carter et al., 2003).
- 4 A shari'ah audit must be performed at least on yearly basis, and the results must be included in the corporation's annual report. Auditors are responsible for the entire company's financial integrity (Cumming et al., 2021; De Haes et al., 2019).
- 5 Shareholders, demand depositors, regulators, financial market authorities, the Islamic Economic Community, and, last but not the least, the general public are all stakeholders in Islamic enterprises. All of these parties along with their interests should be thoroughly analyzed and cared for by Islamic corporations within the confines of shari'ah (Hajawiyah et al., 2020).
- 6 The parties to whom the Shari'ah Committee owes a duty of care must be given a right to sue the Shari'ah Committee's part is proven in case of sheer negligence (Ho et al., 2015).

The literature suggests that the following factors should be included as antecedents of Islamic Corporate Governance:

### **Shariah Board**

Shariah board comprises of Shariah experts having best knowledge and expertise in Shariah jurisprudence. The issues regarding business can be tackled in several ways by different Shariah scholars having diversified knowledge and competencies hence boosting innovations. More clients will be attracted by different Shariah board members or scholars, this can in turn help businesses to enhance their productivity and efficiency (Grachev, & Bobina, 2006).

### **Shariah Audit/Review Committee**

The Islamic financial institutions comprises of an independent Shariah review or audit committee which act as a governing body to keep track of Shariah activities. The main duty of this committee is to supervise, direct and review the activities and transactions in the light of Islamic jurisprudence. While Shariah board takes care of the Shariah compliance of the financial products and transactions (Echchabi & Aziz, 2014; Kolsi & Grassa, 2017). The role of Shariah audit is assisting the Shariah board in reviewing and monitoring the day-to-day activities. In IB context, it has been seen that financial performance of a firm can be increased by quality Shariah audits and reviews (Othman & Ameer, 2015).

### **Shariah Board Size**

Jensen & Meckling (1976) presented the agency theory stating that principal and agents are interconnected in a firm. The company being principal appoint Shariah Supervisory Board (SSB) as an agent that works on company's behalf. Shariah members are very crucial in the usefulness of Shariah Board. Shariah jurists are members of Shariah boards being aware of the financial markets and having expertise about financial laws of Islam. Each Shariah board must consist of at least three experts having competencies and experiences in relevant domain (Kolsi & Grassa, 2017). There is a consensus on maximum number of Shariah board members being at-most seven (Zeineb & Mensi, 2018).

## Board Independence

The investors being principals of the company appoint Board of Directors (BOD's) as agents. The management of the company in no way should control the leadership of the board as BOD's are supposed to efficiently and effectively monitor the day to day activities of the business. If the BOD is independent, there would be efficient performance, better and unbiased decision making prioritizing the interests of shareholders. In Islamic Banking context, the independent board is thought in aiding in a better performance of the firm (Mollah & Zaman, 2015).

## Chief Executive Officer Duality

CEO acting as a board president refers to CEO duality. The agency theory by Jensen and Meckling (1976) specifies that routine activities of the top management are observed by assigning duties to the agents in order to overcome the agency problems. Agency theory focuses that the CEO must have distinguished responsibilities as compared to the board chairman (Antwi, 201; Fama & Jensen, 1983; Jensen & Meckling, 1976). The responsibility of the CEO is to manage the day-to-day tasks while chairman's duty is to control and develop policies and strategies for the board (Zeineb & Mensi, 2018).

<b>Table 1</b> <b>DEVELOP POLICIES AND STRATEGIES FOR THE BOARD</b>					
Structure	Independence	Heterogeneity	Monitoring	Shareholder Activism	Disclosure
No Duality	Retired CEO should not be hired as Chair	Combination of culture, age, ethnicity	Good reputed directors	Institutional Investors	Executive compensation
Independence of the Audit Committee	Familiarity with the management	Representation of genders should be well balanced	System of self-evaluation	Minimizing corruption through SH activism	Full disclosure
Evaluation of the board should be formal	Share ownership should be dispersed		Competent audit committee	Effective family representation	
Unlimited directorships					

## METHODOLOGY

The exploration of antecedents requires a subjective approach. This study applied both qualitative approach to carry out research. The reliability of the items of the scale will be tested on context and content basis. The exploration of antecedents is to be done in two phases.

### Phase One: Item Generation

The first phase comprises of establishment of items. The approach used for item generation is inductive and deductive approaches based on opinions of the target population and literature available. The items were developed taking lead from the literature. Shariah board comprises of Shariah experts having best knowledge and expertise in Shariah jurisprudence. The Islamic financial institutions comprises of an independent Shariah review or audit committee which act as a governing body to keep track of Shariah activities. Jensen & Meckling (1976)

presented the agency theory stating that principal and agents are interconnected in a firm. The investors being principals of the company appoint Board of Directors (BOD's) as agents. CEO acting as a board president refers to CEO duality (Morgado et al., 2017).

### **Phase Two: Theoretical Analysis**

The subsequent phase includes theoretical analysis and final phase includes scale evaluation (Sharfman, 1996). The Phase two comprises of content validity. This is to test validity of the construct. The qualitative approach was used to get a response of experts and normal layman in Islamic corporate governance. The scale was developed and the items were sent to experts working in Islamic finance sector for testing the reliability.

The data of the study was collected through corporate and academic sector of Pakistan. The executives and the middle level management were the population for the study. The second phase also required the selection of population, hence, professors of Islamic university or universities with Islamic department were selected. The study included 5 executives who were chosen using convenient sampling from LinkedIn. Five professors were selected from top five universities of Pakistan. The same sample panel was also contacted whenever the study demanded (Morgado et al., 2017).

## **RESULTS AND DISCUSSION**

The conventional corporate governance and Islamic corporate governance were seen to be same in majority of the cases. The difference lies in the fact that Islamic corporate governance is based on Shariah and the stakeholder's perspective. The Islamic corporate governance adopted its antecedents from Shariah rules and regulations. Islamic corporate governance overcome the agency dilemma because the concept of taqwa over powers any self-interest and breach of trust. The management and the board will both be working for and accountable to Allah. Hence, the double accountability system will lower the risk of Breach of trust and frauds. The experts in the field agreed that heuristic phenomena will be more successful in Islamic corporate governance because the board will not serve its own financial purposes. Their main aim will be protection of the property and trust of all stakeholders.

An expert commented that the duality reduces effectiveness of the board, that's because two different people will bring more expertise. Hence, will lead to better firm performance. Another expert stated that the board members should not be hired as chairman after their retirement from the board. This will make board transparent and independent. The family owned businesses should find a way to make board independent and reduce their influence. The board composition should be framed as such that it should include a mix of controlling and non-controlling shareholders and management. Pakistan has people from different ethnicities and most businesses affect all of them. Hence, for representation board should comprise of realistic mix of cultures. This will increase sense of ownership and identity in shareholders.

The challenge for corporations in Pakistan is that finding a sincere and good reputed leadership is hard. The reputation is an objective concept, hence, it changes with a change in board. The board's effectiveness and efficiency should be evaluated by a neutral third party. A 360 approach should be employed, that is the board members should be evaluated individually, as well as part of the board. The compensation of the directors should always be linked to the wealth of shareholders. This will be an in built check on board members to safeguard shareholders interests. Islamic corporate governance enforces that the information if hidden may result in a

loss will be considered a sin. The information is only relevant for decision making if it is disclosed on time and is complete. Hence, any information that maybe relevant for the stakeholders should be disclosed completely and on time.

## CONCLUSION

Islamic corporate governance and conventional corporate governance differs mainly in adoption of Shariah laws and stakeholders perspective. This study's results may not be generalized because sample was only taken from Pakistan. However, the antecedents maybe relevant for other industries as well with some modifications. The most important drivers of Islamic corporate governance are Structure, Independence, Heterogeneity, Monitoring, Shareholder Activism and Disclosure. The theoretical contribution of the study is that the study explored antecedents of Islamic corporate governance adoption in organizations. The practical implication of the study is that identification of Islamic corporate governance practices may now be easy to evaluate. The scope of the study is limited, the future researchers should increase the sample size and develop scale based on these or some more antecedents.

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