CORPORATE GOVERNANCE AND SHARIAH GOVERNANCE ISSUES AMONG SHARIAH-COMPLIANT COMPANIES IN MALAYSIA: A CONCEPTUAL PAPER

Norhanim Mohamad-Zainal

PhD, Universiti Utara Malaysia,
Lecturer, Faculty of Management and IT, Universiti Sultan Azlan Shah,
Bukit Chandan, 33000 Kuala Kangsar, Perak, Malaysia Tel: +60173729156 E-mail:
neym83@gmail.com

Abstract

Corporate governance plays an important role for the economic health of the organizations and society in general. Islamic businesses are currently gaining worldwide acceptance, Malaysia is becoming a centre for Islamic business activities. The concerns for Shariah compliance have brought a new dimension of governance which falls under the Shariah governance framework. To comply with Shariah laws, companies listed in Bursa Malaysia are classified as Shariah-compliant and non-shariah compliant. Therefore, the corporate governance practice among Shariah-compliant companies in Malaysia should be consistent with the Shariah laws. Thus, this conceptual paper aims to highlight the issues and challenges of Shariah governance among Shariah-compliant companies in Malaysia. This paper extends current literature on corporate governance especially the Shariah governance practice in Malaysia. Therefore, the issues and challenges in Shariah governance that were emphasized through this paper should be able to assist the regulators, industrial players, Shariah advisors and researchers in Malaysia.

Keywords: *Corporate Governance, Shariah Governance, Shariah-Compliant, Issues*

INTRODUCTION

Corporate governance is a term often used to explain the way a company is managed, audited and held accountable. The term governance has become an important concept in a variety of different disciplinary and practice arenas including management, public administration, public policy and others. It has its roots in a Latin word meaning to steer or give direction. Although corporate governance has long been in existence, the awareness of it grew in the later half of the 20th Century in the West. In Malaysia, corporate governance only became an issue during the 1997 economic crisis (Tze, 2003). The Asian Financial Crisis of 1997 particularly affected Malaysia, one of the main contributors being the weak corporate governance practices of Malaysian companies. Some of the weaknesses identified were lack of transparency, disclosure and accountability.

PricewaterhouseCoopers (2011) reported that Transmile Group Bhd had an overstatement of its group income to the tune of RM530 million between the 2005 and 2006 financial periods. Hence, resulted in the shareholders losing value in the prices of their shares and subsequently delisted from the Bursa Malaysia on the grounds of employee dissatisfaction, image loss, decline in reputation, and corporate relationships (PricewaterhouseCoopers, 2011). Nevertheless, corporate governance has become a common and controversial issue last few decades specifically on the role of board of directors in enhancing the performance of firms. Literature on corporate governance in the Malaysian context is still relatively new and there is much to be studied in this area. Malaysia has established the code of corporate governance in 2000 which was revised in 2007, 2012 and the latest in 2017. The new Malaysia Code of Corporate Governance (MCCG) places greater emphasis on the internalization of corporate governance culture, not just among listed companies, but also encourages non-listed entities including state-owned enterprises, small and medium enterprises (SMEs) and licensed intermediaries to embrace the code.

The MCCG is recommended to all listed companies including the Shariah-compliant companies. Shariah-compliant companies or Shariah approved companies are companies on Bursa Malaysia with core activities which are not contrary to the Shariah principles (Securities Commission, 2018). Hence, companies whose activities are in conflict with the Shariah rules are classified as non-Shariah compliant companies. As at 30th November 2018 there are 689 number of Shariah-compliant securities listed on Bursa Malaysia or 76 % of total listed securities (Bursa Malaysia, 2018). In Malaysia, the Islamic capital market with Shariah-compliant companies is expected not to engage in activities that go against the religion code of conduct (Sanusi et. al 2015). Malaysia with its unique historical background, multi-culture and religions with the majority of its population being Muslims has become a hub for Islamic business activities. As far as Islam as a religion is concerned, it is considered as a significant force in influencing accounting matters (Sulaiman, 2001).

Most of the available literatures were discussing the relation between corporate governance and Shariah governance, and how those governance concepts are handled at Islamic financial institutions. However, only a few discussed on Shariah-compliant companies. Thus, the following sections discuss the corporate governance and the issues and challenges among Shariah-compliant companies.

CORPORATE GOVERNANCE

All religions in Malaysia preach ethics, good conduct and responsibility, which should lead to good corporate governance and better performance, if applied in business entities. Good corporate governance needs to be rooted in a corporate culture that reinforces ethical, prudent and professional behaviour especially in Shariah-compliant companies. This begins with the right "tone from the top", where the example set by the board and senior management shape the core values of an organization (Kassim, Htay & Salman, 2013). Therefore, Shariah board members play a crucial role to guide the management. The management should be responsible to implement it in all aspects of the operating activities. The good corporate governance should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities. Good corporate governance also includes the values of accountability, transparency, responsibility, and integrity.

The word 'Islam' stands for, among other things, peace, purity, submission and obedience. Islam does not separate religious deeds from political, economic or social affairs. Furthermore, Islam encourages individuals to be involved in business and hence has clearly articulated commercial law to guide Muslims regarding the types of businesses that are lawful and those that are unlawful. The fiqh (Islamic law) prescribes the nature of allowable trade and services which generally requires justice, fairness, and honesty in all business transactions. Fiqh explicitly forbids transactions which are unclear, unfair, unjust and fraudulent.

According to Alam, Hassan and Said (2015), Islam provides a set of principles, regulations and laws that are collectively known as Shariah. Shariah has a common objective (Maqasid) that seeks the betterment (Masalih) of mankind under a divine (one god: Allah) guideline. (Alam, Hassan and Said, 2015; Alkdai and Mustafa, 2016) acknowledged that based on Islamic belief, the term Maqasid Al-Shariah refers to the objectives of Islamic law. Muslims are anticipated to behave in accordance with the beliefs of their religion, which should be reflected in management behavior and company actions. Thus, the proper governance identifies the distribution of rights and responsibilities between the company and its stakeholders.

SHARIAH COMPLIANT STATUS

The importance of the Shariah-compliant listed companies in contributing to the Malaysian economic growth is undeniable (Hooy & Ali, 2017). The Malaysian Shariahcomplaint companies include large and small, private and public companies from different sectors namely consumer products, the consumer products, industrial products, mining, construction, trading and services, properties, plantation, technology, infrastructure, finance, hotels and closed-end fund. Part of Malaysia's pioneering efforts to create an organised and efficient Islamic capital market was the establishment of the Islamic Capital Market Department (ICMD) and the Shariah Advisory Council (SAC) in 1996. The Shariah Advisory
Council is also responsible for screening, reviewing and identifying the process for attaining Shariah compliant status. There are two parameters considered in the selection process qualitative and quantitative.

a) Qualitative Parameter

The initial focus is on the goals and services offered by the company using a set of criteria that have been formulated as basic guidelines in the selection process (Securities Commission, 2018). Companies that carry out any non-permissible core activities will not qualify as Shariah compliant. Non-permissible activities encompass: financial services based on riba (interest); maisir (gambling); the manufacture or sale of nonhalal products or related products; conventional insurance; certain entertainment activities that are not permitted according to Shariah; the manufacture or sale of tobacco-based products or related products; broking or trading in securities that are not Shariah-approved securities; and other activities that are regarded as not permitted according to Shariah.

For companies with activities comprising both permitted and non-permitted elements, the Shariah Advisory Council considers two additional criteria: (1) the public perception or image of the company and (2) whether the core activities of the company are important and considered beneficial to Muslims and Malaysia. The non-permitted element must be very small and involve matters which are common and difficult to avoid, or are customary and are rights of the non-Muslim community which are accepted by Islam.

b) Quantitative Parameters

The second stage of evaluating Shariah approval requires assessment of relevant quantitative parameters. The Shariah Advisory Council has established several benchmarks in order to determine the tolerable level of mixed contributions from permitted and nonpermitted activities, based on reasoning from the source of Shariah by qualified Shariah scholars (Securities Commission, 2018). The securities of the company will be classified as Shariah compliant if the contributions from non-permissible activities do not exceed the following benchmarks:

a. A five percent benchmark for activities that are clearly prohibited such as interest, gambling, liquor and pork.
b. A ten percent benchmark for activities that involve elements that affect most people and are difficult to avoid, such as interest income from fixed deposits in conventional banks, and for tobacco related activities.
c. A twenty percent benchmark for non Shariah-compliant activities such as rental payments from premises that are involved in gambling, sale of liquor etc.
d. A twenty-five percent benchmark for activities that may affect the Shariah-approved status such as hotel and resort operations, share trading, stock broking and other activities that are not Shariah approved.
e.

The Securities Commission compiles the decisions of the SAC and published the list of Shariah-compliant stocks twice a year in April and October, however the issuing date was changed in 2007 to May and November in order to coordinate with the Bursa Malaysia Shariah Index. The list of Shariah-compliant stocks gives investors, especially Muslims, the necessary guidance, opportunity and confidence to select and invest in the listed securities or companies that comply with the Shariah principles (Securities Commission, 2018).

AGENCY PROBLEMS

Agency theory discusses the problems that surface in the firms due to the separation of owners and managers and emphasises on the reduction of this problem. This theory helps in implementing the various governance mechanisms to control the agents' action in the jointly held corporations**.** The principal or the owners, who invest their capital and take the risk to acquire the economic benefits, whereas the agents, who manage the firm are risk averse and concerned in maximising their private benefits. Both the principal and agent are having opposite risk preferences and their problem in risk-sharing creates the agency conflict, which is broadly covered under the agency theory (Fama & Jensen, 1983).

Awareness of the potential drawbacks of agency problems has grown enormously over the past decade. By now it has become widely accepted that companies are exposed to agency issues whereby the separation of ownership and control leads managers to seek their personal interests at the expense of those of shareholders (Fama & Jensen, 1983). The reinforcement of the role of the board of directors and the tightening of audit and control mechanisms came to serve this purpose. The concept of corporate governance as "a set of relationships between a company's management, its board, its shareholders, and other stakeholders," has quickly emerged, fueled by the desire to mitigate recurring incidents of agency problems (OECD, 2004). In addition to that, shariah prohibits riba (interest), gharar (speculation), and the trading of money, and it calls for alternative modes of trading where the underlying products are real assets or services. Previous research of corporate governance at conventional corporations suggests certain compensation schemes linking managers' compensations to performance to align their interests with those of shareholders (Core, Guay & Larcker, 2003).

Thus, without a doubt the contract structure of organizations that separate the ownership from control gives rise to agency problems resulting from the fact that the agents or managers do not bear the risks or the "wealth effects of their decisions" (Fama & Jensen, 1983). These issues not only relevant to conventional corporations but also to Shariahcompliant companies.

ISSUES AND CHALLENGES

The Shariah governance established in an Islamic Financial Institutions adds an additional layer of governance to the existing corporate governance structure of the Institutions. The following are some of the issues of corporate governance identified related to Shariah-compliant companies.

a) Shariah Board directors

The Board of Directors are to assure that the organization is operating according to the intention of the shareholders while the Shariah board ensures that the organization is running based on Shariah rules as well as to assure the shareholders that their investment is running in a permissible manner. In this perspective the Shariah board is central to corporate governance arrangements, and its main function is to act as a monitoring device to control management. This control is necessary so that the behaviour of management is aligned to the shareholders' best interests.

In general, principal - agent theory, or agency theory for short, has been the dominant theory of corporate governance arrangements in the economics and finance literature. It is based on the assumption that the owners of an enterprise (the principal) and those that manage it (the agent) will have different interests. Hence the owners or shareholders of any enterprise face a problem that managers are likely to act in their own interests rather than to benefit shareholders. While free markets are seen as the best restraint on managerial discretion, agency theory sees corporate governance arrangements as another means to ensure that management acts in the best interests of shareholders (Short & Keasey, 1999).

Nevertheless, the religion of Islam bans any opportunistic behaviour to achieve selfinterests. Thus, many aspects of this perspective have relevance to the Shariah-compliant companies, and therefore study by Kasim, Htay and Salman (2016) suggested that, the concept of Shariah and conventional corporate governance should be integrated in order to ensure that Shariah board members can monitor its operating activities according to Shariah Law.

b) Independence Board Directors

Another means of reducing the problems arising from agency theory is to engage independent directors to sit on the board (Hart, 1995). Almost all public listed companies comprises of many small shareholders. These minority shareholders are in no position to control the company and do not have the power to influence decisions made by the board. As a result, all these minority shareholders collectively are unlikely to monitor the company. Shariah-compliant companies also not to be excluded with this issue (Hussain et al., 2016)

Furthermore, stewardship theory (Donaldson and Davis, 1991; Muth and Donaldson, 1998) is grounded in a human relations perspective and starts from opposite assumptions to agency theory. It assumes that in general, managers are motivated by more than their own narrow economic self-interest. Managers want to do a good job and will act as effective stewards of an organisation's resources. As a result executives and shareholders of the organisation are better seen as partners. Hence, the main function of the board is not to ensure managerial compliance, but to improve organisational performance.

Applying this perspective with Shariah-compliant companies, the role of a governing body including the independence Shariah board members is primarily strategic, to work with top management to set the direction of the organisation, add value to top decisions and improve performance. Hence the independence board directors is seen as an instrument to protect the shareholder rights at the same time the Shariah board members can align the management with the Shariah Law.

c) *Shariah Literate of the Board members*

The internal mechanisms monitor the progress and activities of the organization and take corrective actions when the business goes off track. Therefore the existence of directors who understands the Shariah principle would facilitate effective oversight and protect the industry from overall reputation risks. Qualifications or the experience of Shariah advisors is the key to judge and support the development of Shariah compliant within business. In absence of this, there is a risk that for short term profits or gains the shareholders and the Board of directors may become willing to compromise on the Shariah principles.

The presence of Shariah literate directors would discourage precedence of profit motive over Shariah Compliance. The key element of Shariah supervision is existence of a mechanism that ensures that the shariah-compliant companies continue to remain viable and growing without compromising the principles of Shariah.Thus the responsibilities of Shariah Board Directors include oversight of management to ensure and monitor the business operating activities in accordance with Shariah Law.

Table 1 below shows the lists of the basic roles and responsibilities of governance bodies and, in relation to compliance with Shariah. Scholars, researchers, and international organizations have all stressed the importance of a Shariah Board Directors, which can reassure stakeholders that the Shariah-compliant companies's activities comply fully with Shariah law.

Table 1: Basic Roles of Governance Bodies

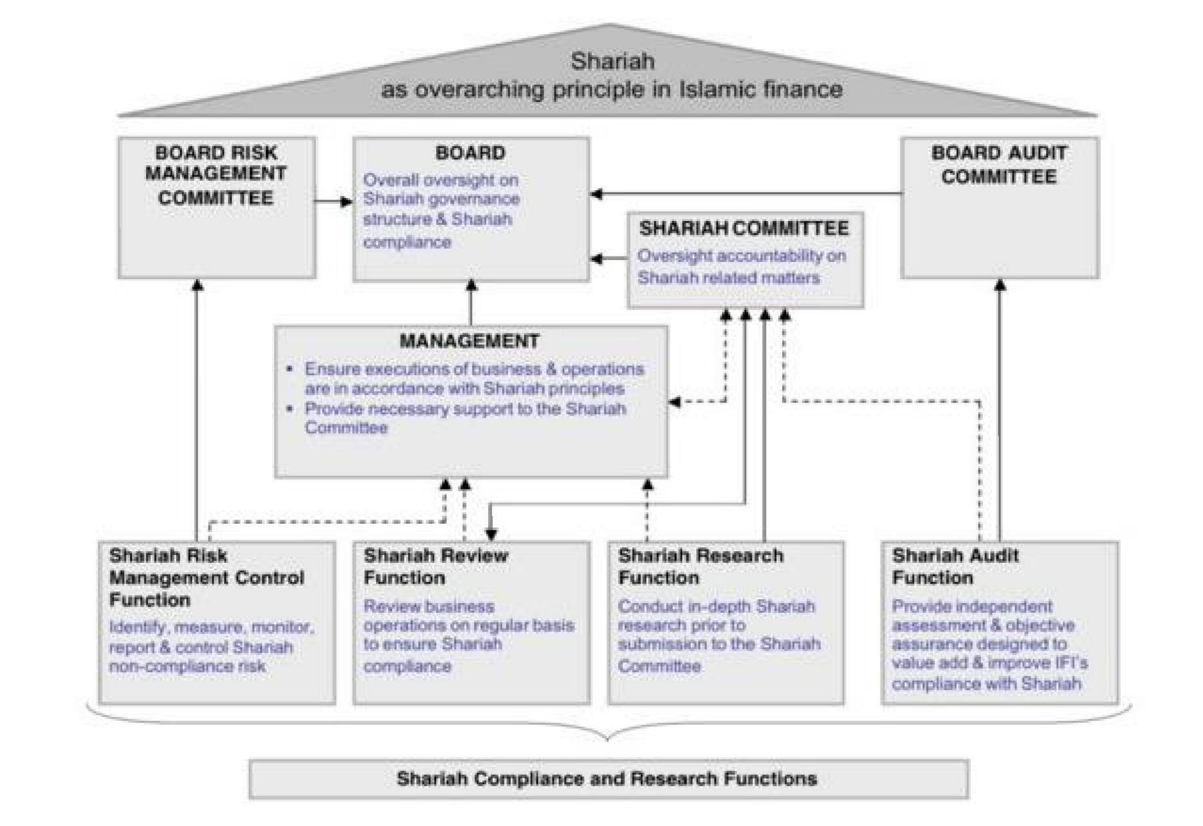
Governance Bodies	Roles
Board of Directors	∑Set and approve overall policy and strategy ∑Monitor progress toward corporate objectives ∑Ensure accountability of the management ∑Protect Shareholders and Investment depositors rights
Shariah Board Directors	∑Set Shariah-related rules and principles ∑Provide a clearance of Shariah compatibility of all products ∑Oversee compliance and its verdict as to create confidence with respect to compatibility with Shariah
Internal Control	∑Ensure management oversight ∑Recognize and assess risks ∑Detect problems and correct deficiencies

Internal Audit	∑Ensure that the policies set by the board are followed by the management
External Audit	∑Ensure the accuracy of the quality and quantity of information ∑Ensure that the financial statements are prepared according to the accepted reporting standards ∑Ensure that the profit has been derived without the violating the teachings of Shariah
Audit Committee	∑Review and supervise the financial reporting ∑Provide oversight of internal and external auditors
Compensation Committee	∑Monitor the compensation policy of senior management and key personnel
Nomination Committee	∑Provide assessment of the Board of Directors' performance ∑Replace board members

Sources: Chapra and Ahmed (2002)

Figure 1 below shows the Shariah Governance Framework Model for Islamic Financial Institutions established by Bank Negara. The Shariah Framework should be existed for Shariah-compliant companies to ensure the good governance while comforming with Shariah law.

Figure 1: Shariah Governance Framework Model for Islamic Financial Institutions.



Source: Bank Negara Malaysia (2010)

CONCLUSION

The harmonization of Shariah principles and current business affairs has become a norm in business transactions. There should be a high standard of reporting that provides adequate information to the shareholders and regulators. The existence of Shariah board members, Independence board members and the qualification or the Shariah literacy of the board members can enhance the good corporate governance practice. Corporate governance framework should ensure, in order to provide relevant information for investors’ decisions, that the disclosure is timely and accurate on all material matters, is in accordance with high quality standards of accounting and disclosure and the audit and review of these disclosures by independent, competent and qualified auditors is carried out. Moreover, there should be a high level of transparency and market discipline to build the trust of the shareholders and investors. It can be summed that the ultimate objective to achieve Shariah compliance can only be achieved by the collective supports from all involved parties. Therefore the issues highlighted in this paper must be addressed to ensure the main objective good corporate governance which includes the values of accountability, transparency, responsibility, and integrity among Shariah-compliant companies can be achieved.

REFERENCES

[1[Alam, M. M., Hassan, S., & Said, J. (2015). Performance of Islamic microcredit in perspective of Maqasid Al-Shariah: *A case study on Amanah Ikhtiar Malaysia. Humanomics*, 31(4), 374-384.

[2] Alkdai, H. K. H., & Hanefah, M. M. (2012). Audit committee characteristics and earnings management in Malaysian Shariah-compliant companies. *Business and Management Review*, 2(2), 52-61.

[3] Bank Negara Malaysia (2010). Shariah Governance Framework for Islamic Financial Institutions. Viewed 23 November 2019 http://www.bnm.gov.my

[4] Bursa Malaysia, 2018 viewed 30 November 2018http://www.bursamalaysia.com

[5] Core, J. E., Guay, W. R. and Larcker, D. F. (2003) *Executive equity compensation and incentives: A survey, Economic Policy Review*, 9: 27–50.

[6] Chapra, M. U. and Ahmed, H. (2002) *Corporate Governance in Islamic Financial Institutions, Islamic Development Bank,* Islamic Research and Training Institute, Periodical Document No. 6.

[7] Donaldson, L., & Davis, J. H. (1991). Stewardship theory or agency theory: CEO governance and shareholder returns. *Australian Journal of management*, 16(1), 49-64.

[8] Fama, E. F. and Jensen, M. C. (1983) Separation of ownership and control, *The Journal of Law and Economics*, 26: 301.

[9] Hooy, C. W., & Ali, R. (2017). Does a Muslim CEO matter in Shariah-compliant companies? Evidence from Malaysia. *Pacific-Basin Finance Journal*, 42, 126-141.

[10] Hussain, M. A., Hassan, R., & Azhar, A. (2016). To Appoint Shariah Committee Member as an Independent Non-executive Director of Islamic Banks in Malaysia: Issues and Challenge. *International Review of Management and Marketing*, *6*(8S), 138-141.

[11] Kasim, N., Htay, S. N. N., & Salman, S. A. (2013). Conceptual Framework for Shari'ah Corporate Governance with Special Focus on Islamic Capital Market in Malaysia. *International Journal of Trade, Economics and Finance*, 4(5), 336.

[12] Kasim, N., Htay, S. N. N., & Salman, S. A. (2016). Empowering the Shari'ah Committee towards Strengthening Shari'ah Governance Practices in Islamic Financial Institutions. *Review of European Studies*, 8(2), 142.

[13] Mohd-Sanusi, Z., Ismail, R., Hudayati, A., & Harjito, D. (2015). Screening Process of Shariah-Compliant Companies: The Relevance of Financial Risk Management. *International Journal of Economics & Management*, 9(1).

[14] Muth, M., & Donaldson, L. (1998). Stewardship theory and board structure: A contingency approach. *Corporate Governance: An International Review*, 6(1), 5-28.

[15] Organization for Economic Cooperation and Development (OECD) (2004) *OECD Principles of Corporate Governance, OECD*, France.

[16] PricewaterhouseCoopers, L. L. P. (2011). Global economic crime survey

[17] Securities Commission (2018), Retrieved on 10 Disember 2018 from https://www.sc.com.my/

[18] Short, H., & Keasey, K. (1999). Managerial Ownership and the Performance of Firms: Evidence from the UK. *Journal of corporate finance*, 5(1), 79-101.

[19] Sulaiman, M. (2001). Testing a model of Islamic corporate financial reports: some experimental evidence. *IIUM Journal of Economics and Management*, 9(2), 115-39.

[20] Tze, WKL 2003, Corporate governance in Malaysia and the recent reform, viewed 9 December 2018,http://www.maicsa.org.my/technical_essay. htm