

CORPORATE GOVERNANCE IN PAKISTAN

(An Analytical Study from *Shariah* Perspective)

(A dissertation in partial fulfillment of the requirements for the award of LLM/MS
in Islamic Commercial Law)

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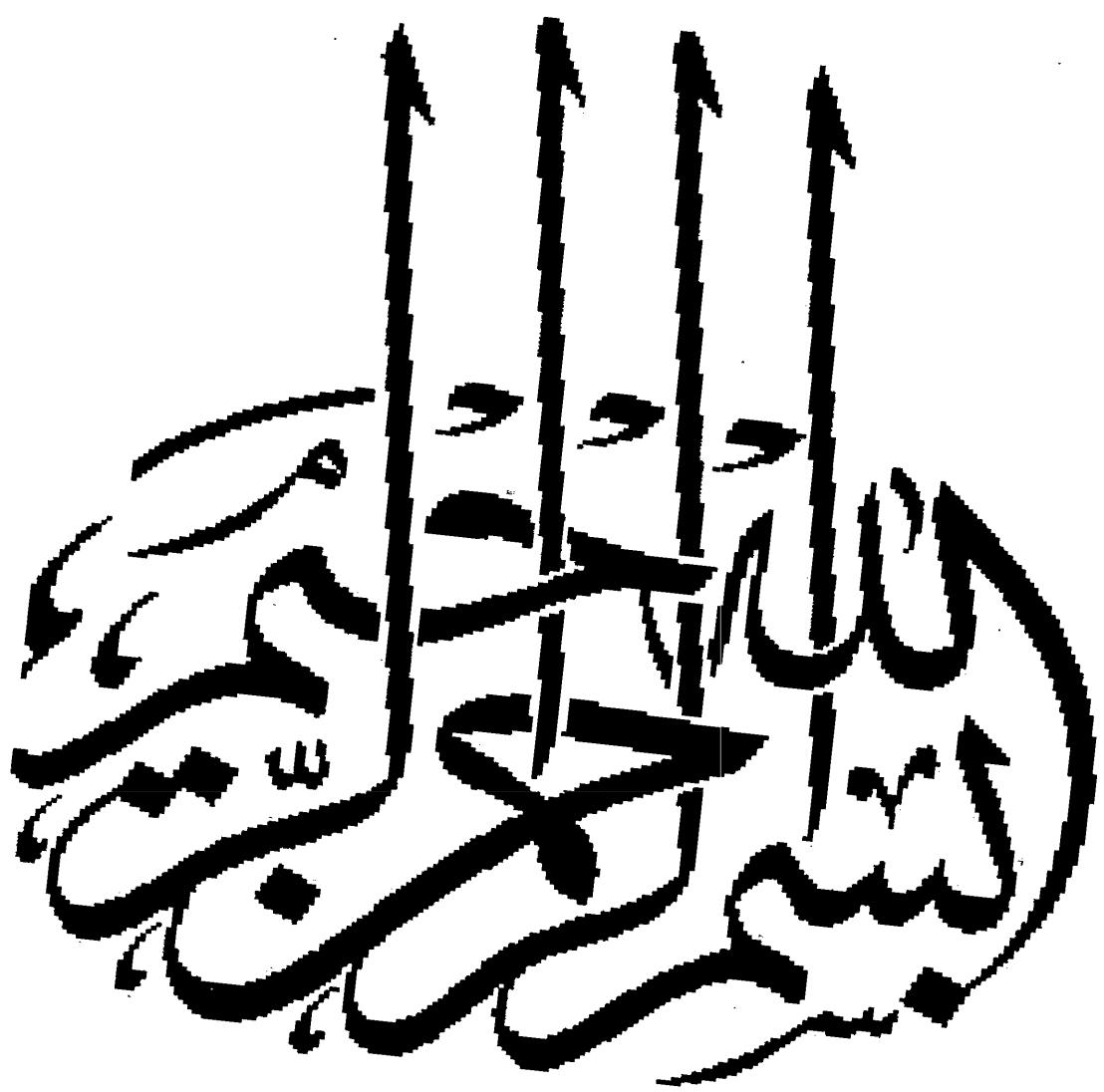
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Dedication

This thesis is dedicated to

my Father, who taught me that the best

kind of knowledge to have is that which is learned

for its own sake. It is also dedicated to my late Mother (May Allah almighty

shower His countless blessings on Her departed soul and have Mercy on her! Ameen!).

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADB	Asian Development Bank
ASX	Australian Securities Exchange Commission
BOD	Board of Directors
CEO	Chief Executive Officer
CMO	Chief Marketing Officer
COO	Chief Operating Officer
OECD	Organization for Economic Cooperation Development
GAAP	Generally Accepted Accounting Principles
GDP	Gross Development Product
GM	General Manager
ICAP	Institute of Chartered Accountancy Pakistan SBP State Bank of Pakistan
SECP	Security and Exchange Commission of Pakistan
UNDP	United Nations Development Program
PPC	Pakistan Penal Code
CRPC	Criminal Procedure Code
CPC	Civil Procedure Code
NAB	National Accountability Beuru
IFI	Islamic Financial Industry
SSB	<i>Shariah</i> Supervisory Board
ISA	Internal <i>Shariah</i> Audit

AOA	Articles of Association
IA	Internal Audit
IIFM	International Islamic Financial Market
LMC	Liquidity Management Centre
SSB	<i>Shariah</i> Supervisory Board
SAC	<i>Shariah</i> Advisory Council
SSC	<i>Shariah</i> Supervisory Committee
NSB	National <i>Shariah</i> Board
SSs	<i>Shariah</i> Standards
IFSB	Islamic Financial Services Board
FSC	Federal <i>Shariat</i> Court
SAB	<i>Shariat</i> Appellate Bench

SUMMARY

This dissertation is an academic investigation to simplify the concept of Corporate Governance in Islamic Perspective with special reference to its general principles in *Shariah*, Pakistani Corporate Governance policy and its application in Islamic Financial Institutions across Pakistan. The need for Islamic sense of corporate governance is severely felt in the contemporary corporate governance practices across the Muslim world in general and in Pakistan in special. The empirical questions that the study poses are the answers to these questions, that how business organizations should be run and governed in compliance with the spirit of *Shariah*? To what extent the corporate governance mechanism in Pakistan protects the interests of all the stakeholders and society at large? What are the laws, regulations and procedure followed in Pakistan for the governance of Islamic Financial Institutions? All these questions and the gap between the theory and practice is discussed and explored in this research.

The study describes the associated values of corporate governance which are addressed in *Shariah* in broad terms. It proceeds further to critically analyze practices of corporate governance in Pakistan. The related laws, i.e. The Code of Corporate Governance 2004, and scattered statutory provisions, i.e provisions in Companies Ordinance, 1984, National Accountability Ordinance 1999(modified up to 2010) and other laws applicable to this doctrine are also discussed and the issues are pointed out.

The thesis also emphasizes on the need of *Shariah* based codified Islamic banking laws as a requirement and legal mean for regulating the business of the Islamic banks and considers it very much important and pulse of the Islamic financial institution,

to be implemented under the preview of *Shariah*. It also points out the need for the implementation of Federal *Shariat* Court's and Supreme Court's Judgments on *Riba* and the observance of Islamic business principles in the business operations carried on by corporations and Islamic financial institutions across the country.

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INTRODUCTORY CHAPTER

1. Introduction and significance

Corporate governance is a mechanism necessary for running a business organization in accordance with the objectives of the company. These objectives are set by a structure provided by corporate governance mechanism. It also provides and guides the business entity regarding the sources and means to be utilized for attaining these objectives. The need for governance of business organizations has been severely felt since the last two decades. A number of corporate scandals in which prominent corporations were involved such as Enron, WorldCom, Global Crossing and so forth, caused for the highest level significance of good governance practices. This remained not merely the demand of public concerned but also of the corporate entities to observe a high level of corporate governance practices for avoiding such kinds of scandals.

The weaknesses in accounting principles, and financial accounting give enough room to the management of the corporation to use these principles and provisions for their advantage harming the cause of corporations. For example the weaknesses pointed out in United State's Generally Accepted Accounting Principles (GAAP) and Financial Accounting Standards Board (FASB) were utilized by management of the Enron Corporation and they inflated income of the corporation.

Corporate governance mechanism provides a structure which does not merely prevent such kind of practices by the management and other stakeholders of a corporation

but also points out the means to treat these kinds of issues. Good governance practices will definitely guarantee the corporation's survival for a long term.

The directors have to consider the interest of all the stakeholders especially minority shareholders and ignore their own interest. For example the directors in Enron were given an award of \$400 million in response to their achievement of the stock price's target although the fact was that the company's financial position was not good. This was the result of conflict of interest where the interests of directors, shareholders and other stakeholders were in tussle.

Discussing the literature regarding corporate governance in *Shariah*, the literature is thin in about this new conceptual terminology. But the Idea behind this concept is not alien to Islam. Generally the principles which are necessary for corporate governance in *Shariah* have been discussed by Muslims scholars. For example the Institution of *Hisbah*, the concept of *Ihtisab* and *Hisaab* and their relation with the accountability, the concept of *Twahid* (Unity of God) Who is the ultimate owner of the capital and the man's role to act as vicegerent (*Khalifah*) in managing the capital and wealth according to the directions ordained by Allah (S.W.T). In *Shariah* the objectives of corporate governance are to ensure that a highest degree of accountability and transparency is exercised in achieving fairness to all stakeholders of the corporation.

The study is of great significance, it can be said that the secular and man made practices of governance are only dealing with the related party and self dealing transactions and the transactions which are operated in ordinary course of business are not dealt. But *Shariah* looks at the transactional structure applying the general business principle of permissibility and prohibition. A faith based approach is applied in *Shariah*

governance practices and humanist values are not relied upon. But the values of accountability, honesty, trustworthiness and transparency based on the paramount principles of Islam are to be exercised. This faith based approach can contribute to the good governance of business entities and safeguard of shareholders rights. The codes of corporate governance are based on humanist values and there is need to internalize these Islamic values into the Muslims (especially those who play role in running a corporation), corporate governance will work effectively.

The various standards and regulations issued by a number of boards such as Accounting and Governance Standard No 2, Islamic Financial Services Board's Guiding Principles on *Shariah* Governance System and Corporate Governance Principles for Islamic Financial Institutions have played a key role in developing an effective governance mechanism for Islamic financial Institutions and other business organizations. The Pakistani regulatory authorities of corporations and financial Institutions are in need to incorporate the *Shariah* based governing regulations utilizing the above mentioned standards and rules. Further these governing regulations must be implemented according to their spirit for achieving the goals of maximizing the capital of shareholders through permissible trade and transactions and fulfillment of the religious duties owed towards Allah-the Exalted.

2. Background of the Research

The study is aimed to focus on the imperative questions surrounding the corporate governance in Pakistani corporations and Islamic financial institutions. The conceptual idea of governance is discussed in *Shariah* perspective as well. The question of this study

is that whether the Pakistan framework of corporate governance is in compliance with the faith based values of governance in *Shariah* or not? The significance of the question is that being Muslims we need to run direct and control the operations of business entities in accordance with the principle envisaged by Islam. Otherwise the violation of the Islamic values for running the business operation will happen, and maximization of profit and self-interest will only remain the main objectives of these entities. The study will elaborate the role of directors, managers, auditors and shareholders in corporate governance. The role of all these stakeholders' key position holders will also be prescribed in a *Shariah* governance framework. This will hopefully help the key position holders namely: the directors, managers, auditors, shareholders and other stakeholders to know about their moral religious and legal duties to run manage and direct the business organization. The study will focus on the paramount principles of Islam for running, directing and governing corporations. The study will seek to answer the question from the perspective of finding the humanist values, self-interest and conflict of interests as objectionable elements in the western corporate governance frameworks.

The study will further look the legal framework for governing the corporations and Islamic banks operative across Pakistan. The role of governing bodies such as security and exchange commission of Pakistan (SECP), Institute of chartered accountancy Pakistan (ICAP) and the state bank of Pakistan (SBP) will be elaborated. It will critically analyze different sections of relevant Laws and regulations and will point out how these governing provisions are in need to be modified /substituted. It will further argue that the tow distinct principles of Islamic, i.e. the prohibition of *Riba* (Usury) and

entitlement to profit is based on liability to bear the loss (*Al-Kharaj Bil-Dhaman*) are violated in a number of Laws.

The study will have a glance on international governance principles, standards, rules and regulations utilized, issued and adopted in the governance of Islamic financial institutions and will point out a number of issues in functioning of the supervisory bodies such as *Shariah* supervisory board (SSB) and *Shariah* advisors. It will look on the current governance framework of Islamic banks and the need for amendments in a number of laws will be suggested and justified. It will be argued that corporate governance framework in Pakistan is in need to be applied in accordance with the true spirit of paramount governing and business principles of Islam.

3. Scope for research and analysis

The study considers the imperative question that what are the *Shariah* issues in corporate governance mechanism working in Pakistan? The study clarifies that it is only a faith and *Shariah* based corporate governance which is acceptable to Pakistani corporations and public. Being Muslims we can't deviate from the revealed universal values necessary for *Shariah* governance framework. At least there is need for incorporation of *Shariah* business principles which will hopefully point out the need for codification of *Shariah* based code of corporate governance and Islamic banking laws. The study will also analyze the international governance practices from the perspective of *Shariah* and it will explain the role of all the position holders and stakeholders in a corporation both from western perspective and Islamic perspective. The main theme of the study is to give a general idea about corporate governance practices in Pakistani

Islamic financial institutions, Pakistani corporate governance policy and corporate governance from *Shariah* perspective.

4. Approach of Study

The approach of the research study is analytical and the Pakistani governance framework has been analyzed from *Shariah* perspective. The Holy *Qur'an* , the Traditions of the Holy (S.A.W), the classical books written in Islamic Jurisprudence such as *Al -Hisbah Fi-al-Islam*, *Ihya Ulumuddin* (Vol. II), (*Al-Mustasfa*) Translated as (A return to Purity).the Accounting, Auditing and Governance Standards of Islamic Financial Institutions No issued by AAOIFI, "Strategic Plan for Islamic Banking Industry of Pakistan", "Risk Management Guidelines for Islamic Banking Institutions" and "Prudential Regulations for Corporate and Commercial Banks" issued by the State Bank of Pakistan will be consulted. A number of books, articles and research papers written by modern Muslim Scholars, researchers and western writers will be consulted. Certain laws, acts and regulations such as Banking Companies Ordinance, 1962, Companies Ordinance 1984, 1973 Constitution, The State Bank of Pakistan Act 1956, National Accountability Ordinance 1999, Code of Corporate Governance,2005, State Bank of Pakistan's "Draft Instructions and Guidelines for *Shariah* Compliance" will be discussed. The Holy *Qur'an* will be cited in the manner that first the word *Qura'n* will be mentioned, then the number of chapter (*Surah*) and then the number of verse will be mentioned, for example, Qur 'an 2:24.

The explanatory notes will be mentioned in footnotes for the introduction of an author, elaboration of a terminology used in the middle of research text. References will be cited in the footnotes wherever is essential.

5. Structure of the Thesis

The whole thesis will be divided into five chapters. Chapter number one will discuss the conceptual idea regarding corporate governance like definitions of the term, significance of this mechanism, historical overview, principles of corporate governance, and the role of directors, managers, auditors and shareholders in corporate governance. Chapter number two will proceed to the main body of the research and will discuss the framework of corporate governance applied in Pakistan. A number of governing and regulatory provisions will be discussed and the key issues faced by Pakistan will also be pointed out. Chapter number three will focus on the idea of corporate governance from *Shariah* perspective. The definitions, the associated values such as *Shariah* Audit, Accountability, trustworthiness transparency and their relation with corporate governance will be elaborated. Further the Islamic duties and functions of the board of directors, management, auditors (external and internal)/*Shariah* auditors will be prescribed in detail.

Chapter number four will narrow down the research to the practical implication of the Islamic Idea of corporate governance in Islamic Banks in Pakistan. The term will be defined from the Islamic banking perspective and conventional banking perspective. The significance of corporate governance for Islamic finance, the historical overview Islamic banks, the role of SBP, the criteria for the member of *Shariah* supervisory board, *Shariah*

advisor both at central and institutional level, their functions and duties, the key issues faced by a *Shariah* board's member will be discussed and the chapter will be summed up with the corporate governance model of Pakistani Islamic banks. Finally chapter number five will sum up this research and will draw conclusions with some recommendations.

CHAPTER 1

THE JURISPRUDENCE OF CORPORATE GOVERNANCE

1.1 What is Corporate Governance?

The term “corporate governance”, although seems to be the new terminology.

Hence has been elaborated as:

“The term corporate governance means the relationships among management, the board of Directors, Shareholders, and other stakeholders in a company. These relationships provide a framework within which corporate objectives are set and performance is monitored.”¹

The Organization for Economic Cooperation Development (OECD) Principles 1999 provides a more comprehensive and more meaningful definition as:

“Corporate governance is a system which provides a structure through which the objectives of the company are set, and the means for attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in interests of the company and shareholders and should facilitate effective monitoring; thereby encouraging firms to use resources more efficiently”.²

¹ Ahmed M. Khalid, Muhammad Nadeem Haneef” *Corporate governance for Banks in Pakistan. Recent developments and Regional Comparisons*” CMER working paper, Publisher (Centre for Management and Economic Research, Lahore University of Management Sciences Lahore) May 2004, p.1

² Ibid

“Corporate governance can also be described as the process in which the company is administered and controlled by a few parties such as board of directors, management, auditors etc. These parties have the duty to ensure that the company is heading towards the mission as well as the vision of the company. At the same time they are also accountable to the company’s stakeholders.”³

The Finance Committee on corporate governance (1998) in Malaysia describes corporate governance as:

“The process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objectives of realizing long-term shareholder value, whilst taking into account the interest of other stakeholders”.⁴

The above definitions denote that corporate governance is a three dimensional system, which regulates the relationships among the three bodies of a company. For example, relationship between the board of directors, management and shareholders of the company. Each of them has legal obligations which are necessary to be performed by them for achieving the aims of a company.

The discussion above is evident that corporate governance is another name of accountability, which provides the degree of accountability of the management to shareholders (owners) and other capital providers.⁵

³ Ali Adnan.Ibrahim “*Convergence of corporate governance and Islamic Financial Services Industry towards Islamic Financial Services Securities Market*” Georgetown Law Graduate Paper Series Paper 3, Publisher (Berkeley Electronic Press, bepress) 2006,p.10

⁴ Asri Mohammad, Fahmi Mohammad “*Contribution of the Islamic Worldview towards Corporate Governance*” p.8; also see <http://www.iiu.edu.my/.../Asri%20and%20Fahmi%20IWWandCG.htm> – Last Accessed on 12/11/2008 AT 05:40 PM

⁵ Al-Jarhi Mabid “*Issues of corporate governance in Islamic Financial Institutions*” a presentation for the conference on Corporate Governance in Islamic Financial Institutions, Beirut March 21,22 2000

1.2 The Importance of Corporate Governance

In this part of the research the significance of this governing framework will be discussed in quite detail. Since the idea of governing the business entities was put forward to protect not merely the interests of these entities, but also to improve a balance in the relations of all stakeholders.

Corporate governance is an enabling condition that enforces the financial disciplines, enables the injection of transparent rules and procedures instead of direct and personal interventions, and protects public assets from undue appropriations by insiders. Improved corporate governance is particularly important, because it involves strengthening and developing institutions, building administrative and monitoring capacity and political support⁶

Corporate governance is important for the growth of a country's economy and enhancement of business environment. It is evident that countries that ensured the good and proper governance practices have observed a rapid improvement and growth in corporate sectors and became able to attract capital than those that do not implement such good governance practices.⁷

Hani Kablavi states the significance of good governance practices in the following words. He says:

“The adoption of best practices standards is a matter to be addressed by regulators or rule-makers. However market participants with a vested interest in the development of

⁶ Domonique,Pannier “*Corporate governance of public enterprises in transitional economies*” Publisher (world Bank Publications) 1996 p.v

⁷ Security and Exchange Commission ““*Manual of Corporate Governance*” Publisher (Securities and Exchange Commission of Pakistan, Jinnah Avenue Islamabad 40000 Pakistan Paragraph 2.14,pp.7,8

sustainable local capital markets can also play a role in evaluating corporate governance standards by setting market expectations for an acceptable corporate behavior".⁸

A competitive market may be established by implementing good and proper corporate governance.⁹ Bad governance practices can seriously harm the financial status of a number of people such as investors, savers, suppliers and consumers. The policy makers in developing countries must consider that corporate governance is of vital importance for the improvement of their economies.¹⁰

Keeping in mind the crisis which has been faced by various economies of the world, we may say that corporate governance plays a role of back bone for a country's economy. Therefore little concern, if given in the developing countries, would certainly cause for the infringement of the rights of stake holders, investors and especially of the minority shareholders. It would be a major mistake if the institutions did not consider proper reforms in governance structure of the corporations.

As corporate governance is leading to firm's success, therefore Adam Smith emphasizes on a highest degree of vigilance and careful dealings on the part of managers for securing the wealth of the people with which they are entrusted¹¹ It is derived that the significant objective of corporate governance is to ensure the accountability of certain individuals in a company or organization, through means that try to eliminate or reduce the principle agent problem. The principle agent problem (agency problem) is that the principle and agent may not have the same interests, while the principle is, presumably,

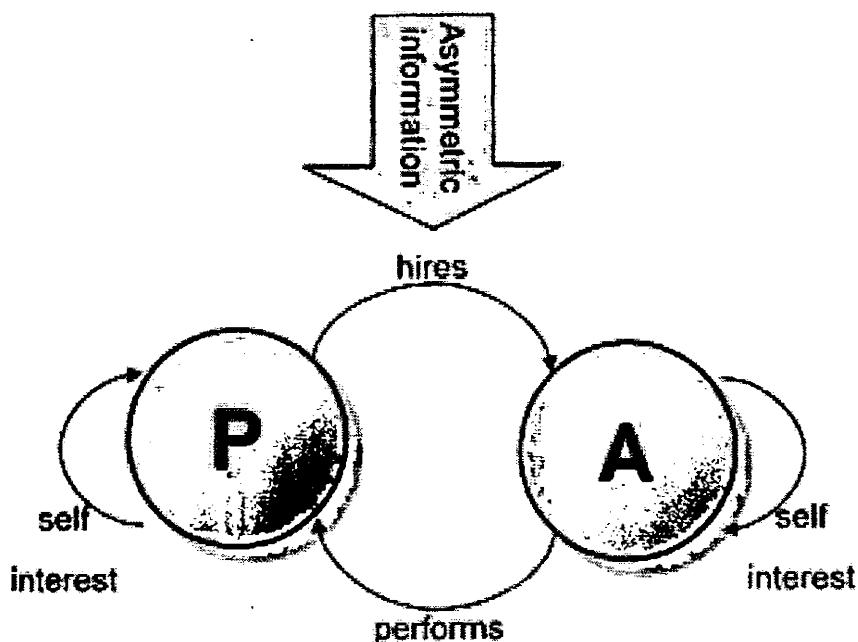
⁸ Hani Kablawi "Improving Corporate Governance in Islamic finance" Innovation Series Research Paper, Global Corporate Trust Publisher (The Bank of New York Mellon) 2008 ,p.3

⁹ Security and Exchange Commission of Pakistan Code of Corporate Governance, 2005, p.7

¹⁰ Charlesp.Oman "Corporate governance in development: The experience of Brazil, Chile, India and south Africa." Paper Publisher (Center for International Private Enterprise- OECD Development Centre Publishing) 2003 p.5,6

¹¹ Smith Adam, Andrew S. Skinner "Wealth of Nations" volume 2 Publisher (Penguin Classics) 1999.p.25

employing the agent to achieve his own interests. The principle agent problem has been shown in the following figure where both have their own interests.¹²



Governance of corporations is a framework which encompasses policies, processes and people. It is a system which serves the shareholders and other stakeholders¹³ through a mechanism of directing and controlling the activities of management. Accountability, integrity and objectivity are its main principles necessary for those activities. A concrete board culture for the safeguard of policies and processes must also

¹² Agency Problem has been defined in the contemporary literature of finance a "corporate governance deals with the ways in which suppliers of finance to corporations assures themselves of getting a return on their investment Governance in Islamic"(Shilfer and Vishney, 1997 , page 737) as quoted by Karim Mimoun in his Book "*Corporate Banks: The Handling of a Complex Agency Problem*" p.6

¹³ Traditionally the term" stake holders "includes, share holders, suppliers, customers, the community and staff of the corporation. See "*Corporate truth: the limits to transparency*" by Adrian Henriques p. 39

be observed in better governance. The test of the effectiveness of governance is the degree to which any organization is achieving its purpose.¹⁴

1.3 The principles of corporate governance

The principles of corporate governance developed in different countries, codes are formulated and issued from stock exchanges, corporations, foreign investors or institutes of directors and managers such as the Combined Code of corporate Governance, Security and Exchange Commission of Pakistan Code of Corporate Governance,2005 and OECD Principles of Corporate Governance,2004.Governments and international organizations also support them. It is pertinent to mention that application of those recommendations and principles is not mandatory under the law, but the codes are linked to stock exchanges, and if any company requires to be listed with stock exchange, then those codes may have a coercive effect upon that company.

Dr. Jesus Estnislao says in his research paper presented at Centre for International Private Enterprise Development Institute writes:

“...Performance-related to corporate governance invites every corporation to be fair not only to the controlling majority shareholders but also the minority shareholders..... It’s also fairness to all of the stake holders, including fairness to employees –how employees are treated? Fairness to the economic system, fairness to the political community in which the corporation operates so that they pay the right taxes, do not bribe, and do not participate in corruption”¹⁵

¹⁴Colley John L Logan George, Stettinius Wallace ;” *Corporate governance*” Publisher (McGraw-Hill Professional, New York) 2003 p.11

¹⁵Estnislao Jesus;” *Corporate Governance in Emerging Markets*” research paper Publisher (Centre for International Private Enterprise) August 2008, p.4

He adds:

"All of this gets incorporated into corporate governance, designed for performance that is supposed to deliver results. So fairness and transparency become an important responsibility to be able to show every one that the corporation has nothing but the best results of all of the share holders, without any exception. All of the transactions must be transparent. Report must be transparent according to the international financial reporting systems..."¹⁶

It is quite clear from the above principles that the main objective of corporate governance is to provide a framework, through which transparency, fairness and responsibility is ensured in a corporation, as there is a clear link among these principles. The benefits are observed and the objectives are gained through a common contribution in the implementation of these paramount principles of corporate governance. The important elements which are required for good governance also include honesty, trust and integrity. Mutual respect responsibility and commitment to the corporation also have a significant role in the improvement of governance.

1.4 OECD Principles of Corporate Governance

The Organization for Economic Co-operation and Development (OECD) formulated the principles of corporate governance, which are as following:

1. Ensuring the basis for an affective corporate governance framework¹⁷

¹⁶ Ibid

¹⁷ See OECD Principles of corporate governance Publisher (OECD Publications Service) 2004 p.17

2. The rights of share holders and key ownership functions. The corporate governance framework should protect shareholders' rights. This framework should perform two functions:
 - i .It should represent a general conceptual framework for establishing shareholders property rights.
 - ii. It should recognize the separation of ownership and control and should propose specific approaches to solving the agency problem.
 - iii. It should not argue for one share-one vote rules but should advocate transparent financial markets.¹⁸
3. The equitable treatment of shareholders:¹⁹ It can be explained that corporate governance should protect the rights of all shareholders (Minority and foreign) and if any of their rights are violated, they should be given redress for that violation.
4. The role of stake holders in corporate governance: The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders...²⁰
5. Disclosure and Transparency²¹: It means that frame work of corporate governance must observe that all the important matters regarding corporation (financial situation, performance, and governance of the company etc.) are accurately disclosed timely.

¹⁸ Ibid p.18

¹⁹ Ibid p.20

²⁰ Ibid p.21

²¹ Ibid p.22

6. The Responsibilities of the Board: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the share holders.²²

From the above principles we may conclude that there is a relationship between shareholders, managers, and the directors. Directors have fiduciary duty to share holders, and the directors also must have greater independence since it improves the quality of oversight. The management and the shareholders share a principle –agent relationship.

1.5 The Historical Overview of Corporate Governance

Corporate governance has a complicated history but we will confine its history to a general theme not the details.

The Family business is shown in the history to be the first large business especially in states with short industrial history.²³ The writers of its history have primarily focused on in large firms, for small firms everywhere tend to have controlling shareholders.

In the AD1600, the East India Company, which started its business with 218 members and was governed by committees named the Court of Directors where the governance structure emerged which consisted of the General Court OR Court of proprietors and the Court of Directors. The Court of Directors was made up of all those with voting rights, the qualification for which in the early days was normally an investment of 200 pounds. The Court of Directors was the executive body and was

²²Ibid p.24

²³ Morck.Rnadall K and Lloyd Steier "The Global History of Corporate Governance-An Introduction" National Bureau of Economics Research working paper 11062.January 2005, p.5

responsible for running of the company, although its policy decisions had to be ratified by the Court of Proprietors. The Court of Directors consisted of the Governor, the Deputy Governor and twenty four directors.²⁴

The governance structure of East India Company was therefore little different from that of a company of today. The Court of Proprietors were the shareholders in general meeting, the Court of Directors were the board assisted by appropriate subcommittees, and the Royal Charter laid down the boundaries within which the company had to work. The court of Directors had to select the Chief executive in making their first appointment to that position. Their admirable policy on selecting their executives, as relevant now as it was then was not to appoint any gentleman in any place of charge. They were responsible for the financing of the company's enterprises.²⁵ Here a problem faced by the board. Their shareholders differed in their motives for investing in the company and in their time horizons. The board also had the problem of controlling its appointees, who were acting not only for the company but also often for themselves, in distant stations and out of touch for long periods. This made the selection of the company's captains and factors a crucial board responsibility.²⁶

The upshot of this reference to the way in which the most influential company in Britain was run some four hundred years ago is that its structure and the responsibilities of its board are clearly recognizable to those in charge of companies today. Corporate governance has therefore with us since companies began to take their present form.²⁷

²⁴ Cadbury Adrian "Corporate Governance and Chairmanship: a personal view Oxford" Oxford University Press, 2002, p.2

²⁵ Ibid p.3

²⁶ Ibid

²⁷ Ibid

It is crystal clear that the basic issues of the corporate governance are those of accountability and power. These two issues involve the questions, that where power lies in the corporate system? And to what extent accountability is there for its exercise? The necessary point is that the power's balance is continuously changing between the boards of directors, managers, shareholders and other stakeholders and these changes bring the governance issues in front. For understanding the importance and significance of corporate governance it is necessary to look at the manner in which it has developed, but the changing balance of power between the boards of directors, managers, shareholders and other stakeholders must be kept in mind.

1.6 Corporate Governance in 19th Century

In the nineteenth century, two important measures of company law were there which were particularly relevant in terms of governance .i.e. The joint Stock Companies Act of 1844, then came the Limited Liability Act of 1855. The number of limited companies increased in the 19th century, due to which the importance of corporate governance also increased.²⁸ As early as 1965 Wedderburn, in response to the Cohen and Jenkins²⁹ Committee, established to consider the wider aspects of corporate governance, urged that company law was in need of reform. He contented that directors should consider the interests of employees, creditors, consumers and wider public interest. The

²⁸ Ibid, p.4,5

²⁹ Cohen and Jenkins committees were set up for reforms in the company law. See "Corporate Governance and Corporate Control "By Saleem Seikh and William Rees, Publisher (Routledge Publishers, UK) 1995 p.2

corporate governance debate in the UK needs to address their wider issue of directors 'duties towards other potential claimants on the corporation.³⁰

Till the early 1990s, the term corporate governance did not pass into common usage. The UK's Cadbury Report of 1992 was the first that discussed corporate governance in detail. By the late 1990s, World Bank and IMF reports also emphasized on the need for good governance practices. Although in early 2000s in the UK and US, corporate governance faced problems such as in 2002 the American political classes registered certain complaints regarding the irresponsible behavior in companies having bad business history.³¹ During the last three years the issue of corporate governance came under most scrutiny for a verity of scandals in business. In 1997 the East Asian Financial crisis seriously affected the economies of East Asian countries after the collapse of property assets.

When we study more about the history of corporate governance, we come across the commentaries of some writers who emphasize for the technical solution of more governance, which can achieve the purpose and aims of the corporation. But here the aim is to give a brief and authenticate prescription of the corporate governance necessary for understanding the importance of responsible corporate behavior. As we observe that the corporate governance delivered much in the early 1990s as long as the capital remained with the companies for investment. The Cadbury report of 1992, although did not present the Idea, but it was a document which aimed the corporate governance to be its

³⁰Seikh Saleem , Rees ,William; " *Corporate Governance and Corporate Control* " Publisher (Routledge,UK) 1995 p.2

³¹Ismail Erturk; Julie Froud; Sukhdev Johal; Karel Williams " *Corporate governance and disappointments*" Review of International political economy" Publisher (Centre for Research on Socio Cultural Change and Manchester Business School, University of Manchester in Review of International Political Economy) volume 11, Issue 4 October 2004, p.678

object for discussion. It defined the term, discussed the review structure of the board and its responsibilities, the rights and responsibilities of the shareholders and the best practices of corporate governance. The report also addressed the financial aspect of corporate governance and has a concern with failure of major companies.

The current system of corporate governance is the result of the bad actions of authority holders in corporations.³² The history shows that when the corporate scandals came to forefront, the East Asian Economic crisis of 1997, the protests of American political class in 2002 and of British media in 2003, against the weak controlling mechanism paved a way for the evolution of corporate governance.

1.7 Corporate governance and the board of directors, managers, auditors and shareholders

This part of the research deals with the responsibilities, powers and rights of the directors, manager's auditors and shareholders of a company. The shareholders are the owners of a corporation. The Managers manage it, in this situation it is presumed that they will give preference to their own interest and managerial decisions favoring their short and long term interests and goals, would be made. The conflict of interest is never appreciated. The directors are elected for the service of business, and they are considered the representatives of owners, so they will act in the interest of those owners. Although the conflict of interest is a big issue faced by governance mechanism but there is no room in good governance practices for such a conflict. The reason is that the shareholders

³² Colley John L Logan George, Stettinius Wallace ;" *Corporate governance* " Publisher (McGraw-Hill Professional, New York 2003 p.4

entrust the higher authority holders in a corporation for providing a safe guard to their interests rather than their own interests.

1.8 Corporate governance and the board of directors

The main Principle

The UK combined code of corporate governance 2006 mentions principles indicating the importance of the board of directors for company, its liabilities and powers such as: “Every corporation should have an effectively working board of directors, to be held collectively responsible for the success of corporation.”³³ The supporting principle of the same code mentions further that it is the responsibility of the directors to take decisions aimed for achieving the interests of the company.”³⁴

The directors of corporations are the representatives of a business and they work for the interests of other owners who can not represent themselves. Here the problem of conflicts of interests exists. The directors undertake a serious fiduciary obligation. Effective representation, however, requires more than integrity. It also requires the competence to make sound decisions. Good directors know their limits and turn to more expert advisors when their judgment so dictates. Directors who are “dumb but honest” fail to fulfill their obligations.³⁵

³³Financial Reporting Council “*The combined code on corporate governance*” Publisher (Financial Reporting Council London) July2006, p.8

³⁴ *Ibid*

³⁵ Op.cit, Colley John L Logan George, Stettinius Wallace ;” *Corporate governance* ” p.13

1.8.1 The Functions of the board of directors

To understand the term “board”, the functions of the directors should be understood. The members of the board of directors are the representatives of shareholders. The Board’s Chairman, the Chief Executive Officer and other managers of the company are elected by the board. Every director of the board is expected to regularly attend meeting of the Board and the Committees on which such board sits.³⁶

The Australian Securities Exchange Commission’s (ASX’s) principles prescribe the responsibilities of the board slightly and more elaborately as:

- a. To oversight the company, including its control and accountability system
- b. To elect the Chief Executive Officer and remove him(if necessary)
- c. To discuss and finally approve the business strategy and plan of the company and
- d. To approve and monitor financial and other reporting.³⁷

The responsibility of the board to guide and monitor the management of company has been favored in various Australian cases. The organization for Economic Cooperation and Development (OECD) signifies it for a better and effective corporate governance framework. The board of directors must ensure a strategy for the guidance of the company’s management, should have an effective monitoring policy, and has to be accountable to the company and shareholders who elect them as their representatives.

Talking all these aspects together, the board’s functions and responsibilities could be summarized as to direct, govern, guide, monitor, oversee, supervise and comply. The

³⁶ Jones lang lasalle Company’s “*Corporate Governance Guidelines*” Publisher (Jones lang lasalle Company Chicago effective of April15 2009 p.2,3

³⁷ Plessis J. J. Du, McConville James, Bagaric Mirko “*Principles of contemporary corporate governance*” Cambridge University Press, 2005 p.56

literature on management and managerial strategy makes a distinction between two primary roles of the board, namely' a performance role and a conformance role.³⁸

Concluding the discussion above The Board of directors owes the responsibility to act as a leader, and judge for directing the business, to ensure the aims of the corporation, to improve the significant policies and their implementation. They board has to capture, monitor and supervise, and for that their honesty, integrity and reliability is to be considered while electing them. Their independence is also a cornerstone of good corporate governance. It's the duty of the management, CEO and shareholders to provide an independent, autonomous and experienced framework to the board.³⁹ The board and the Chief Executive Officer have a constructive and positive working relationship, but board is not afraid to be in tussle on hard issues. CEOs respect the constructive board's role and its creative contribution.⁴⁰ The board must be progressive which evaluates the collective body plus all the individual members of the board in a very professional manner.⁴¹

1.9 Corporate Governance and managers of the company

1.9.1 Management defined

The term “Management” has been defined in various ways, the main theme of all these definitions is the same, and therefore we will rely only on a comprehensive definition of Wikipedia, the free encyclopedia, which defines the term as:

³⁸Op.cit, Plessis J. J. Du, McConvill James, Bagaric Mirko “*Principles of contemporary corporate governance*”p.57

³⁹Leong Ho Khai” *Reforming corporate governance in Southeast Asia: economics, politics, and regulations*” Publisher (Institute of Southeast Asian Studies Singapore) 2005,p.7

⁴⁰Charan Ram ”*Boards that deliver: advancing corporate governance from compliance to competitive advantage*” Publisher (John Wiley and Sons, Hoboken United States) 2005, p.9

⁴¹Ibid, p.10

“Management in all business and human organization activity is simply the act of getting people together to accomplish desired goals and objectives. Management comprises planning, organizing, staffing, leading or directing, and controlling or manipulating an organization (a group of one or more people or entities)”.⁴²

Wikipedia, the free encyclopedia also defines the term management as:

“Management can also refer to the person or people who perform the act(s) of management”.⁴³

The corporate management consists of those who are responsible for managing the business of company. What are the kinds of managers of a corporation? Who select them? and what are their functions and powers? These are the questions to be answered in the following lines.

1.9.2 Senior Managers

Senior Managers are those individuals at the top of company’s management who are responsible for higher level responsibilities, e.g. the board of directors and the owners of company (Shareholders), but they act like managers of the senior management and not of the day-to-day business activities. The senior managers are sometimes called within company, as upper management, seniors, higher management or top management.⁴⁴ Thus senior managers owe a great and important responsibility, not only to the company but

⁴² <http://en.wikipedia.org/wiki/Management> Last accessed on 20/02/2009 AT 03:30 PM

⁴³ Ibid

⁴⁴ http://en.wikipedia.org/wiki/Senior_management Last accessed on 20/02/2009 AT 06:00 PM

also to the other stakeholders of the company of running the business activities in compliance with the policies, requirements and interest of the stakeholders.

1.9.3 General Managers of the Corporation

General Managers or GM in short is a term used for executives in a business activity. General management is also a position held by some company's executives. In some situations a GM is given some different title. Most of them hold the title of Chief Executive Officer or President. They are deemed to be the General Managers of their companies. Some time the Chief operating Officer (COO), or Chief Marketing Officer (CMO) is given the title of General Manager of the business. It depends on the design of the company and accordingly the responsibilities of General Managers are given to Managing Director, Regional Vice President, and Country Manager, Product Manager or Branch Manager.⁴⁵

General Managers and senior managers in co-ordination with the C-level executives or CEO to direct the origination. They establish the objectives and goals and improve the policies for their corporate members to achieve those objectives and goals. A company's goal is a wanted state of deals that the company or organization tries to reach. An objective is a representative which represents a result or reaching point towards which company's struggles are directed. To choose a goal and strategy for achieving it directly affects a company's structure.⁴⁶

⁴⁵ http://en.wikipedia.org/wiki/General_manager Last accessed on 20/02/2009 AT 06:15 PM

⁴⁶ Vallabhaneni S.Rao "Corporate Management, Governance, and Ethics Best Practices" Publisher (John Wiley and Sons, Hoboken United States) 2008, p.105

1.9.4 Functions and Duties of General Managers and senior Managers

General and senior managers are the following level in the management ranking. They are below the C-level executives in ranking and they have to report to one of the C-level executives. Their functions include the implementation of the company's mission, strategies, objectives and goals, which are established by the C-level executives of the company. These two kinds of managers implement the company's mission, strategies, objectives and goals using the struggles and efforts of all subordinate managers which include the line managers , middle-level, staff and lower level managers. If the management design of these general managers and senior managers is poor, the result would be ineffective and inefficient implementation of efforts and failed day-to-day activities of the organization.⁴⁷

1.10 Corporate Governance and auditors of the company

The financial reporting, internal control and external audit is more much significant for a transparent mechanism adopted for achieving the objectives of the company. Internal control aims to control policies, measures and procedures in a corporation, which are made for the safety of assets. This system is designed for the production of information on timely basis, accurate manner, and for running the business in effective and efficient manner.⁴⁸

⁴⁷ Ibid

⁴⁸ Mallin ,Chirss A "Corporate governance" Oxford University Press, 2007Glossary p.xix

The combined code of corporate governance 2006, which influenced the evolution of corporate governance in many countries, signifies its need as a main principle supported by other principles. It prescribes some principles regarding the transparent audit by the auditors of the company as following:

“The board should establish formal and transparent arrangement for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company’s auditors”.⁴⁹

The code further explains that an audit committee⁵⁰ should be established by the board of directors, of minimum three members or where the company is a listed company, of two members, who should be independent directors, being non-executive directors. The board should ensure that at least one member of that committee has financial and recent experience in the field of auditing.⁵¹

1.10.1 The major responsibilities of the audit committee

The combined code on corporate governance prescribes the major responsibilities as such: ⁵²

- a. to monitor the financial statements of the corporation ,to review the important financial reporting decisions contained in the formal pronouncements regarding the corporation’s financial performance;⁵³

⁴⁹Financial Reporting Council “*The combined code on corporate governance*” Publisher (Financial Reporting Council London) July 2006,p.15

⁵⁰ A sub-committee of the board comprising of non -executive directors.

⁵¹ Op.cit

⁵² Ibid p.15,16

⁵³ Ibid

- b. to review the internal financial control of the company and in some cases the internal and risk management mechanisms of the company;
- c. to supervise and review the effective role of the internal audit function of company :
- d. to suggest recommendations to the board for taking the approval of shareholders in general meeting regarding the appointment ,re-appointment, remuneration and removal of the external auditors;⁵⁴
- e. to improve and implement policy on the appointment of external auditors for non-audit services, considering non-ethical guidance about the provision of non-audit services by the external auditors, and to point out the matters which should be considered for an action or improvement ,suggesting for the steps to be taken;⁵⁵

1.10.2 Corporate Governance Functions of the Audit Committee

The Audit Committee is responsible for dealing the corporate governance matters such as reviewing the organization's corporate governance guidelines. These guidelines shall be reviewed by committee on annual basis and it shall ensure their relevancy and their compliance. The committee shall also recommend any amendments required, which are to be approved by the Board.⁵⁶ Any proposed changes in bylaws and Article of Association of the company is also required to be reviewed by the Committee and it shall

⁵⁴ Ibid

⁵⁵ Ibid

⁵⁶ See "Audit and Corporate Governance Charter" p.3 Available on http://www.supertex.com/pdf/mis/supertex_audit.pdf Last accessed on 20/02/2009 AT 07:15 PM

make recommendations to the board. It is also its responsibility to determine the procedure of sending communications by shareholder/s to the board of directors, to recommend a process for the chair of committee to determine any communications of shareholder for reliance to the board and its response, if any. The Audit Committee is also responsible for overseeing that the board and its committees are in compliance with laws and regulations of the land and those promulgated by the Security and Exchange Commission.⁵⁷

1.10.3 Internal and external auditors of the company

The relation of internal auditing activity to corporate governance is somewhat informal. It is the duty of internal auditors to participate in meetings and discuss the matters with members of the Board of Directors. Corporate governance is a mechanism where the combined processes and corporate structure is implemented by the board for informing, directing, managing, and supervising the company's resources, its policies for achieving the goals of company.⁵⁸

Bernd Schartmann defines the internal audit in his book "*The role of internal audit in corporate governance in Europe: current status, necessary improvements, future task*"

as the following:

⁵⁷ Ibid

⁵⁸ http://en.wikipedia.org/wiki/Internal_audit#Role_in_corporate_governance Last accessed on 20/02/2009 AT 08:00 PM

“Internal Audit Function is the department or in some exceptional cases sometimes also an external origination that is permanently in charge of providing reasonable and permanently biased advice....”⁵⁹

The relation of internal auditors to corporate governance is that they help the Audit Committee of the board of directors in performing its duties in an effective manner. The goals of internal auditors should be the similar to those of the corporation. The reason is that they should search for the improvement of the business objectives and not merely for the accounting standard’s satisfaction. They have to seek the ways necessary for the development of the company more than the external auditors do.⁶⁰

1.10.4 The Functions of internal auditors

The basic function of internal auditors is to review and evaluate the activities in an independent and effective manner for ensuring the efficiency and effectiveness of a company’s risk management, internal control system and corporate governance by:

- a. Evaluation of the trustworthiness, adequacy and functioning of accounting operations, and administrative control.
- b. Assurance of prompt results by the internal control system of the company and correct recording of deals and adequate safeguarding of the assets.

⁵⁹ Schartmann Berd “*The role of internal audit in corporate governance in Europe: current status, necessary improvements, future task*” Publisher Erich Schmidt Verlag GmbH & Co, Berlin Germany 2007 p.8

⁶⁰ David Wood “*Increasing Value through Internal and External Auditors Coordination*” Research Paper written for the IIA research Foundation Esther R. Sawyer Scholarship Award March 1, 2005 p.4

- c. Determining the compatibility of the company's business practice with laws and regulations and it's adherence to the company's established policies.
- d. Determining the extent of steps taken by the management of company for dealing with the present and past control loopholes and recommendations of audit report.⁶¹

The responsibilities may also include to:⁶²

- a. Verify that whether the organization has pointed out and dealt with all of the major legal and regulatory requirements or not?.
- b. Search for opportunities and capabilities for shortening the long-term cost and improve performance of the organization.⁶³
- c. Review code of conduct and ethics policies, ensuring their communication to management and their employees on timely basis.⁶⁴
- d. Ensure the application of risk monitoring mechanism across the entire corporate governance functions, supporting the reporting system of corporation and to play a role for performing the best practices of corporate governance.⁶⁵

The above discussion is evident that how much the role of internal auditors is significant for ensuring the accountability and trustworthiness in a company for achieving

⁶¹ Ibid p.14

⁶² "Internal Audit Plays a Pivotal Role in strengthening Corporate Governance" published and devolved material by Crowe Chizek and Co LLC, United States, p.6

⁶³ Ibid

⁶⁴ Ibid p.10

⁶⁵ Ibid

the long-term and short term goals of a company. The business is regulated through their impartial and reliable role. The Audit Committee of the board of directors should act like supervisors of the internal auditors so that they will perform their duties impartially without any influence by managers of day-to-day business.

1.10.5 The Functions of External Auditors

External Audit defined:

External audit has been defined in many ways, but all of these definitions provide for the same theme. Some of them are mentioned here for understanding the term more closely.

The terminology is defined by wikipedia encyclopedia as:

“A financial audit, or more accurately, an audit of financial statements, is the review of the financial statements of a company or any other legal entity (including governments), resulting in the publication of an independent opinion on whether or not those financial statements are relevant, accurate, complete, and fairly presented”⁶⁶

The Guide for Internal Audit in grant assistance for Japanese NGO Projects defined the term as: “External audit usually refer to accounting audits or legal audits”⁶⁷

External audit program is applied for hiring an independent auditor to:

- a. Play a vital role in performing a qualitative financial statement audit.
- b. Verification of internal controls over financial reporting
- c. Perform a full-scope balance-sheet-only audit. or

⁶⁶ http://en.wikipedia.org/wiki/External_Audit Last accessed on 21/02/2009 AT 10:00 PM

⁶⁷ “Guide for Internal Audit procedure in grant assistance for Japanese NGO Projects” Publisher (Ministry of foreign affairs international Cooperation Bureau Japan) April 2009, p.2

- d. Perform any other function agreed-upon its procedure.

The outsourced or co-sourced functions of internal audit are not the part of external audit program.⁶⁸

An efficient external auditing mostly plays a role by providing the board of directors and management of the organization with:

- a. An acceptable assurance regarding the effective role of internal control system over financial reporting, the timely recording of transactions and Business deals of the organization' and the accurate and complete financial and regulatory reports.
- b. An impartial and meaningful view of organization's activities, and procedures of financial reporting.
- c. Communication of the meaningful information to directors and management in dealing with organization's risk management.⁶⁹

1.10.6 The need for coordination between External and Internal Auditors for increasing the value of auditing

The role of auditors is vital especially of internal auditors to get the confidence of investors. After The dishonest and corrupt acts of Enron and WorldCom which caused for the loss of investor's confidence, a step was required to restore their confidence in corporations. Therefore internal auditors have to improve the effectiveness and efficiency of auditing by coordinating their struggles with external auditors.

⁶⁸ Comptroller's Handbook "*Internal and External Audits*" Publisher (Comptroller of the Currency Administrator of National Banks US Department of Treasury) April 2003 p.32

⁶⁹ Ibid p.34

1.11 Corporate governance and Shareholders of the company

Corporate governance is a mechanism which deals with the relationship of a corporation and its shareholders as denoted by its definition. The UK Companies Act 2006 contains the statutory provisions relating to the management of companies with their shareholders. The Act primarily talks about the duties and statutory requirements from the company. The combined Code on Corporate Governance (non-statutory framework) sets out the duties of the company as well of the institutional shareholders.⁷⁰

The revised OECD Principles 2004 provides a more comprehensive and more meaningful definition of corporate governance which covers the following two areas as:

1. Shareholders rights and their ownership: The principle has been elaborated there as:
” The corporate governance framework should protect and facilitate the exercise of shareholders’ rights”⁷¹
2. Stakeholders role: The principle is further explained there as:
” The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises”⁷²

It is very much clear that the board of directors has the obligation to give a proper direction to the company. They hold a highest executive authority of enabling the company to achieve its goals. The absence of monitoring the board will lead to the misuse of authority and power, the result of which shall be the fraudulent behavior of the

⁷⁰ Calder Alan “*Corporate Governance: A Practical Guide to the Legal Frameworks and International Codes of Practice*” Publisher (Kogan Page, London UK) 2008 p.126

⁷¹ Financial Reporting Council “*The combined code on corporate governance*” Publisher (Financial Reporting Council London) July 2006 p.7

⁷² Ibid p.10

board of directors. It shall make decisions for its own benefit ignoring the interest of other stakeholders of the company. Therefore shareholders have to play a vital role for ensuring their interest and the interests of other stakeholders. They should ensure that the interests of all the stakeholders are given priority by the board during the stage of decision making by the board.⁷³ This task can be achieved by deeply monitoring the activities of the company and shareholders with their interests which should be very much able to influence the decision making of the company. For this purpose they should be able to control the composition of the board of directors. But now a days a conflict has been observed that the minority shareholders are deprived of their right to involve in company's decision making process.⁷⁴

It has been observed in the transactions between corporations and their major shareholders that those transactions were not properly vetted by other shareholders. Especially Asian economies are in need to protect properly the outside investors in their companies. The responsibility of directors must be clearly defined for this purpose and the role of boards should be marginal one for protecting the rights of shareholders or the corporation as a whole. The companies which are listed with the stock exchange must show more willingness for the protection of investors.⁷⁵

⁷³ See http://www.iiu.edu.my/.../IslamicWorldview_EffectiveCorporateGovernance_Bahkand_Nazli.doc - p.45 Last accessed on 15/03/2009 AT 10:PM

⁷⁴ Ibid

⁷⁵ Organization for Economic Co-operation and Development, "Corporate governance in Asia: a comparative perspective" Published in Paris France 2001 p. 8

CHAPTER 2

CORPORATE GOVERNANCE IN PAKISTAN

The recent corporate scandals like Enron and WorldCom in the United States, Harris Scarfe and Ansitt in the private Sector in Australia and the New South Wales Grains Board in the public sector, Long-Term capital Management, Paramalat, Stock exchanges and many other corporate entities across the world led the developing economies of the world to strengthen their governance mechanism. It is necessary for strengthening the corporate culture and attracting the investors for the investment of their capital. The present days situation shows that the confidence of public and investors no more stands on the corporation's performance, its organizational framework, board of directors, policies, culture and the behavior of employees. Therefore the reforms in corporate governance affect the national economy as whole especially the emerging market.⁷⁶

Pakistan tried to bring some capital market reforms with a purpose to make these markets more attractive for foreign capital investment. Asian development Bank (ADB) and the United Nations Development Program (UNDP) assisted Pakistan in the implementation of these capital market reforms. The Securities and Exchange Commission of Pakistan (SECP) substantially revised the Code of Corporate Governance with the incorporation of good corporate governance provisions in it.⁷⁷

⁷⁶ Syed Shoeb, Arshad Chohdry Faiza "Corporate Governance in the Financial Sector of Pakistan" Thesis Published on 20th May 2005, p.5-6

⁷⁷ Ibrahim Ali Adnan, " Corporate Governance in Pakistan-Analysis of Current Challenges and Synopses for Future Reforms",p,1 Research Paper available online::

According to Ibrahim Ali Adnan, although the Pakistani code of corporate governance has been the subject of a lot of criticism, however, this will continue to grow up with the assistance of UNDP and ADB. He mentions that the recent work supported the corporate reform in Pakistan by contributing a lot to it.⁷⁸

2.1 The Pakistani Corporation

In this part of research, an overview of the Pakistani corporation will be given and the issues such as its historical background, its evolution and the laws incorporated for dealing the business activities will be discussed. The history of corporations in Pakistan is such that it has been influenced by the English corporation's governance mechanism. The English Companies Act, 1844 offered a milestone to the development of companies in united India. The Joint Stock Companies Act, 1855 was enacted in united India. The provisions of registration of companies had been incorporated for the first time in the same Act of 1855. Then the Indian Companies Act, 1882 was enacted followed by the Indian Companies Act, 1913.⁷⁹

As Pakistan came into being, it inherited the Indian Companies Consolidation Act 1913. In 1949, the same Act was amended and certain provisions were replaced by new provision, some other new provisions of company law were inserted, its name was changed in the same year and it was referred to as the Companies Act, 1913. In the year, 1984, the Companies Ordinance, 1984 was enacted after a long discussion. Before that,

http://www.law.wustl.edu/wugslr/issues/volume5_2/p323Ibrahim.pdf Last accessed on 01/08/2010 at 4:35 pm

⁷⁸ Ibid

⁷⁹ SECP "Manual of Corporate Governance" Publisher (Securities and Exchange Commission of Pakistan, Jinnah Avenue Islamabad 40000 Pakistan) Paragraph 2.16. p.9

Pakistani companies were established and governed under the provisions of the Companies Act, 1913.⁸⁰

The Pakistani corporations are initially regulated by the Securities and Exchange Commission of Pakistan under the provisions of Companies Ordinance,1984, the Securities and Exchange Commission of Pakistan Act, 1997.Certain other rules have regulations (will be discussed latter on) promulgated for regulating the corporate entities in Pakistan. Special Laws and various other regulators may regulate special companies. Listed Companies are regulated by regulations of the respective Stock Exchanges in which they are listed. The State Bank of Pakistan is governing and regulating the banking companies. National power regulatory Authority is regulating the companies' involved in generating, transmitting or distributing the electric power. Similarly, the Pakistan Telecommunication Authority governs companies providing telecommunication services, and the Oil and Gas Regulatory Authority regulates oil and gas companies.⁸¹

The Manual of Corporate Governance points out, that many provisions in the current Pakistani corporate law remained the same as incorporated in the companies Act, 1913. Ultimately, the corporate law in Pakistan is influenced to a great extent by English corporate law.⁸²The Manual of corporate governance further points to the circumstances and situations that influenced and contributed to the evolution of corporations in Pakistan. That those have been different from those prevailed in England or united India at any time. After independence, Pakistan faced challenges and there were opportunities for the development of corporations and corporate culture in Pakistan. Such as the family

⁸⁰ See Manual of Corporate Governance as quoted in "Corporate Governance in Pakistan", Assignment Publisher (the University of Central Punjab) 2002.,p.5

⁸¹ Ibid

⁸² Manual of Corporate Governance, Publisher (Securities and Exchange Commission of Pakistan), p.9

companies and the oldest stock exchange in Pakistan, established in 1949, remained the core entities to that development.⁸³

To conclude, it is stated that the evolution of corporations and corporate culture in Pakistan has been influenced by English corporate Laws as developed in united India, to a great extent. But the role of local culture and circumstances is also vital in this regard. In Islamic finance, we can give the examples of *Takaful* (Islamic Insurance) companies, the regulations issued by State Bank of Pakistan from time to time for regulating the business of Islamic financial institutions. The Islamic banking department of State bank of Pakistan consults with certain other Standards such as AAOIFI Standards, Islamic Financial Services board's principles to regulate the business of Islamic financial Institutions operating across the country.

2.2 Pakistan's Corporate Governance Regime: An overview

The Literature regarding the corporate governance in Pakistan is very much limited. The reason is that Pakistani academic and institutional sphere is lacking of research culture. The international literature available on the subject, has specifically discussed the governance mechanisms of East Asian countries, like China, Thailand, Korea, and Japan-few names-India-among South Asian countries-has been focused a bit in the literature on corporate governance.⁸⁴

Pakistani economy grown impressively in the 80s and early 90s, but after a decade of this growth Pakistan faced serious economic and social decline in the mid of 90s to late 90s. Inflation in those years rose to highest degrees, debts burden increased

⁸³ Ibid, p.10

⁸⁴ Op.cit Syed Shoeb, Arshad Faiza Chohdry "Corporate Governance in the Financial Sector of Pakistan" Thesis Published on 20th May 2005, p.10

substantially, the economic growth rate decelerated and Pakistan had to suffer international sanction as a result of nuclear testing conducted in 1998. The GDP rate decreased year by year and the economy of Pakistan was in its weaker position during the latter years of 1990s. The GDP rate declined from 7.7% in 1991-1992 to 1.7% in 1997-1998.⁸⁵ There were other minor reasons for declination of the Pakistan's economy, such as military coup in October 1999, the 9/11 tragedy and war against terrorism also affected the faith of investors in Pakistan. The growth of economy had to be addressed with certain reforms in the corporate environment, and the international standards for monitoring and governing the corporations had to be considered. To achieve this goal, the Securities and Exchange Commission of Pakistan came up with the Code of Corporate Governance in 2002. The Code was compiled after the analysis of several international corporate governance codes and reports such as:⁸⁶

1. The Cadbury Committee's Code on the Financial aspects of Corporate Governance published in December 1992 (United Kingdom)
2. The Hampel Committee's Report on Corporate Governance published in January 1998 (United Kingdom)
3. King's Report's recommendations (South Africa) and
4. The Principles of Corporate Governance Publisher (the Organization for Economic Cooperation and Development (OECD) in 1999

The SECP Code is considered a milestone which provided the provisions and principles of good governance practices to be implemented in the corporations in

⁸⁵ See the Official Website of the Economic Cooperation Organization for details: www.ecosecretariat.org
Last accessed on 01/08/2008 at 4:31 pm

⁸⁶ Mehwish, Mumtaz "Corporate Governance in Pakistan: Adopt or Adapt" Research Paper Publisher (University of Cambridge. Judge Institute of Management Cambridge Business School). Pp.16,17

Pakistan.⁸⁷ Although the code has been subjected to criticism, which will be discussed in the coming pages under a separate heading. The provisions of other enactments-will be discussed latter on in this chapter-are also applicable to bring reforms in the corporate governance practices, but the SECP code of corporate governance has paved a way for ensuring the exercise of good governance practices in Pakistani corporations. In my opinion, the provisions of those enactments should be implemented according to their spirit by the leaders of the business organizations and courts simultaneously for the observance of better governance practices in Pakistani corporations.

2.3 Regulatory Framework of Corporations, working in Pakistan

The regulatory framework which is active in Pakistan for regulating the activities of corporations may also be termed as regulators. This framework includes the following bodies:

1. Securities and Exchange Commission of Pakistan. This regulatory body regulates all corporate entities, running inside Pakistan and corporate laws of the land are also regulated by this body
2. State Bank of Pakistan-a governing and regulatory Bank for banking sector across the country
3. The Institute of Chartered Accountants of Pakistan (ICAP).This body regulates the accountancy across the country

⁸⁷ Ibid

2.4 SECP Code of Corporate Governance 2002

In March 2002, the Code of Corporate Governance issued by the Securities and Exchange Commission of Pakistan for the establishment of a good governance framework of listed companies.⁸⁸ Exercising its powers under section 34 subsection 4 of the Securities and Exchange Ordinance, 1969, the commission issued directions to Islamabad, Lahore and Karachi stock exchanges to incorporate the Code's provisions in their listing regulations. The code of corporate governance was compiled for the purpose of ensuring best practices by the corporations. The provisions of the code were aimed to direct and control the listed companies with the goals of safeguarding the interests of stakeholders of the companies concerned. Its objectives were to promote market confidence, enhance the performance of corporations and ensure conformance of companies. In compiling the Code under discussion, SECP has benefited from the experience of other countries as well.⁸⁹

The SECP is a government institution and is governed by the Securities and Exchange Commission of Pakistan Act; 1997. The said Act also contains the provisions of Commission's constitution and qualifications required for the appointment of Chairman and Commissioners in the Commission. The duties, powers of the Commission and financial arrangements have also been incorporated in the said Act. A verity of laws is administered by the securities and exchange commission of Pakistan, such as:⁹⁰

⁸⁸ Listed Companies refers to those which are listed on Pakistan's Stock Exchanges

⁸⁹ Op.cit Manual of Corporate Governance, Securities and Exchange Commission of Pakistan Paragraph, 1.2,p.1

⁹⁰ Attiya Javed , Robina Iqbal "*Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing*" Research paper Publisher (Pakistan Institute of Development Economics, Islamabad) 2010, p. 12

1. The Companies Ordinance, 1984: Amended for incorporating the specific provisions having concern with the rights of minority shareholders and implemented in 2002
2. The *Mudarabah* (Floatation and Control)Ordinance, 1980 and
3. The Securities and Exchange Ordinance 1969.⁹¹

2.5 The Scope of SECP Code of Corporate Governance 2002

The code is considered a first step and initiative by the SECP, in an organized implementation of good corporate governance practices in Pakistan. The SECP also requires further measures for refining the principles of good governance practices and for providing knowledge to the stakeholders about the strict implementation of these principles. All these steps will bring a change in the way in which directors of the companies, managers, auditors, shareholders, and other stakeholders in Pakistan think about the corporations and their roles.⁹²

The manual of corporate governance also aimed a relevant control mechanism which is necessary for corporate culture.⁹³ The main goal of the Pakistani code of corporate governance is to reframe the board of directors, so that it may be held accountable to all the stakeholders. It also emphasizes on strengthening the internal control system of the Pakistani corporations. A focus has been made on better disclosure and the internal and external audit requirements of companies listed with the Stock Exchanges have been addressed. Ultimately the said code was incorporated by all the

⁹¹ Ibid

⁹² Syed Jawad, Faiza Ali "Role of Managing Diversity in Corporate Governance in Pakistan: Learning from the Australian Experience" Research Paper, p, 10. obtained through email:fali@efs.mq.edu.au

⁹³ Ibid

Stock Exchanges in their respective listing regulations. Now all the listed companies inside the country have to comply with the provisions of the said code. The code also suggests verity of vital steps derived from the international best practices of corporate governance, such as:⁹⁴

- a. Assigning a greater role to the non-executive directors of the company
- b. Strengthening the rights of minority shareholders
- c. Improvement of the audit and disclosure mechanism and
- d. Ensuring transparency, accountability, and broader representation.

Several other important amendments were made by the SECP⁹⁵ in corporate laws for updating these laws considering the improvements in corporate sector. All the above said Acts and Ordinances were subjected to these amendments. Companies Ordinance 1984 was also the subject of these amendments. The commission forwarded suggestions to the cabinet of government, which were approved in 2002. The said amendment provided that an individual businessman or a single manufacturer would be able for the establishment of a limited company having its entity. This amendment helped in the expansion of corporate sector. The companies were directed to present audited account before shareholders within the duration of four months. The amendment also exempted those private companies which converted into public companies after one year of their registration, from holding their statutory meetings. The amendment made it mandatory that a copy of the details of every meeting should be provided to every director within 14 days of the date of such meeting. The appointment of a full time qualified listed company's secretary has been made a requirement for the affective corporate culture. The

⁹⁴ Ibid

⁹⁵ See generally the official website of Securities and Exchange Commission of Pakistan for more details www.secp.org.pk

amendments incorporated the provisions regarding the removal of company's auditors through a specific resolution to be passed by 3/4th majority. However, new auditors will only be appointed with the approval of commission. The required quorum of a public listed company's meeting has been increased from three to ten members present personally and will be representing not less than 25 percent of total voting power.⁹⁶

To conclude, it is pertinent to mention that all the above reforms were vital and essential for ensuring good practices of corporate governance in the companies and corporate entities. The role of non-executive directors provides for a transparent and fair performance of the executive directors of the company. They are the non-working directors with duties of keeping an eye on activities of executive directors, so that the management of the company will feel free in performing their duties. Ultimately the management will be compelled to comply with the unethical directives issued by the executive directors of the corporation. Similarly the rights of minority shareholders are ignored most of the times, therefore specific provision were needed to be incorporated in the respective listing regulations of the Stock Exchanges. The audit mechanism and the functions of disclosure are also vital for a fair, transparent and free of corruption corporate culture. All these steps were necessary to be taken for obtaining the faith of investors in corporations, their policies and business structure. All the above issues must be addressed by the Securities and Exchange Commission of Pakistan for establishing a reliable, safe and secure corporate culture in Pakistan, which is very much essential for our economic growth and efficiency.

⁹⁶ Attiya Javed, Robina Iqbal "Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing" Research paper Publisher (Pakistan Institute of Development Economics, Islamabad 2010) p, 12

2.6 Enactments applicable to Corporate Governance in Pakistan

The Code of Corporate Governance in Pakistan is considered to be the first milestone for implementing the good practices of corporate governance in Pakistani corporations. However, there are other laws which may also have an impact on the issues of best corporate governance practices. These Laws are categorized by as follows:⁹⁷

1. The corporate Laws, such as : “the laws generally applicable to companies and their business activities; These Laws are : The Companies Profits(Workers Participation) Act, 1968, The Securities and Exchange Ordinance, 1969, The Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance, 1970, The Worker’s Welfare Fund Ordinance, 1971, The Companies (Appointment of Legal Advisors) Act, 1974, The Companies Ordinance 1984, The Securities and Exchange Commission of Pakistan Act, 1979, and The Listed Companies (Substantial Acquisition of Voting Shares and Takeovers)Ordinances, 2002”⁹⁸
2. The regulations and rules falling under the corporate laws such as: “The Companies Profits (Worker’s Participation) Rules, 1971, The Investment Companies and Investment Advisors Rules 1971, The Companies(Appointment of Trustees) Rules, 1973, The Companies (Appointment of Legal Advisors) Rules 1975, The Monopoly Control Authority (Net worth of stocks and Shares)Rules 1977, The Companies (General Provisions and Forms) Rules, 1985The Companies (Registration Offices) Regulations, 1986, The Companies (Invitation

⁹⁷Op.cit Ibrahim Ali Adnan, “*Corporate Governance in Pakistan-Analysis of Current Challenges and Synopses for Future Reforms*”,p,4 Research Paper available online:

law.wustl.edu/wugslr/issues/volume5_2/p323Ibrahim.pdf Last accessed on 02/08/2010 at 8:50 pm

⁹⁸Ibid

and Acceptance of Deposits) Rules 1987, The Companies (Management by administrator) Rules 1993, The Asset Management Companies Rules, 1995, The Monopoly Control Authority (Value of Assets) Rules 1995, The Venture Capital Companies and Fund Managers Rules) 1995, The Companies (Issue of Capital) Rules 1996, The Monopoly Control Authority (Companies of Market Shares) Rules, 1996, The Companies (Issue of Capital Rules) 1997, The Companies (Audit of Cost Accounts) Rules, 1999, The Companies (Rehabilitation of Sick Industrial Units) Rules, 1999 and The Companies Share Capital (Variation in Rights and Privileges) Rules, 2000”⁹⁹

3. The byelaws (Internal Laws) and listing regulations of the stock exchanges¹⁰⁰ in Pakistan
4. A set of general criminal law (Adjective and procedural laws). “For example, Laws providing for the trial and prosecution of those committing criminal breach of trust, fraud, etc.. Such as Pakistan Penal Code(PPC) 1860 and the Code of Criminal Procedure(CRPC), 1898”¹⁰¹
5. A set of general Civil Laws. “For example legislations providing redresses to those claiming declaration¹⁰², enforcement of claims and recovery. These include

⁹⁹ Ibid

¹⁰⁰ Stock Exchange here refers to: A market for the sale and purchase of securities. See Concise Law Dictionary by Muhammad Abdul Basit Publisher (Federal Law House Islamabad) ISBN-978-969-557-023-4 p,634,635

¹⁰¹ Op.Cit

¹⁰² The word “Declaration” here refers to: A statement of plaintiff’s cause for complaint in court action. See the reference above.p.192

:The Specific Relief Act, 1877, The Code of Civil Procedure (CPC), 1908 and The Limitation Act, 1908”¹⁰³ and

6. Special prosecutions of those committing corruption, fraud and misappropriation under the provisions of National Accountability Ordinance 1999 replaced by National Accountability Ordinance 2007.¹⁰⁴

Ali Adnan is of the View that all the above enactments and laws provide for the relevant provisions which offer a foundation to understand the superstructure of corporate governance in Pakistan. This Legislative spectrum has to be understood along with the vision of Securities and Exchange Commission of Pakistan¹⁰⁵.

It is pertinent to mention that if any of the above mentioned laws will be considered in isolation for satisfactory results of corporate governance or for the implementation of good governance practices, the result will not be as effective as in the case of consolidated form of their implementation.¹⁰⁶ The reason for this is that corporate governance is not the name of a single Institution or a Limited concept. It is applicable to all those having concern with the corporation. The study shows that the goals of a corporation may only be achieved by preventing fraud, misrepresentation, corruption, strengthening the rights of shareholders (especially minority shareholders) in the form of return on their capital, payment of compensation for supplying goods and services to suppliers, delivery of goods and services to the customers, ensuring a free and

¹⁰³ Op.Cit

¹⁰⁴ A discussion in this respect will be set out in this Chapter

¹⁰⁵ Op.cit Ali Adnan, Ibrahim “*Corporate Governance in Pakistan-Analysis of Current Challenges and Synopses for Future Reforms*”.p,3 Research Paper available online: Available online: law.wustl.edu/wugslr/issues/volume5_2/p323Ibrahim.pdf Last accessed on 02/08/2010 at 10:31 pm

¹⁰⁶ Op.cit Manual of Corporate Governance, Publisher (Securities and Exchange Commission of Pakistan,) Paragraph 2.1,pp.12-16

independent role of directors, the workers welfare, consultation with the stakeholders in decision making (democratic decision making environment) and by the specific observance of transparency, accountability and trustworthiness.

2.7 The governing and regulatory provisions in Companies Ordinance 1984

In this part of the research provisions incorporated in the Companies Ordinance, 1984 will be discussed. These provisions may be divided as:

1. Sections aimed to prevent Conflict of Interest and promote transparency
2. Sections aimed to ensure disclosure and fair accounts in corporations

(1) Sections aimed to prevent conflict of interest and promote transparency:

These are a variety of provisions incorporated in the statue for the purpose of promoting transparency and prevent conflict of Interest such as:

- a. Loans have been debarred to Directors of the company, any firm in which the such director or relative is shareholder, private company in such a director is member etc¹⁰⁷
- b. Chief Executive Officer of The Company (CEO) has been debarred from engagement in any business competing with the business of the company in which he is an employee. This involvement may be directly or indirectly. He has to disclose in writing the nature of business and his interest, in which he is involved.¹⁰⁸

¹⁰⁷ See S.195 of the Companies Ordinance, 1984

¹⁰⁸ Ibid. S. 203

- c. Public Company has been debarred from offering loans, investments, equity, to its associated companies, except as authorized by special resolution in this regard. This provision does not apply to banking company, financial institution recommended by the Commission for such advancement and to a private company, which is not subsidiary of a public company¹⁰⁹
- d. Disclosure of direct or indirect interest, by the directors, in any contract or arrangement, the nature of his concern and interest has been specified by the said ordinance.¹¹⁰
- e. Other officers of the company have been debarred to enter into any contract or arrangement unless they obtain a prior approval of the directors and disclose the nature and interest in the transaction.¹¹¹
- f. Interested director has been debarred from participation or vote in proceedings of directors¹¹²
- g. The court may declare a director, who violates the above relevant provisions, to be lacking fiduciary behavior¹¹³
- h. The provision for keeping a register of contracts, arrangements, and appointments in which directors etc are interested has also been incorporated in the said ordinance. Certain particulars regarding the contracts, parties, conditions etc shall be entered.¹¹⁴

¹⁰⁹ Ibid. S. 208

¹¹⁰ Ibid. S. 214

¹¹¹ Ibid. S. 215

¹¹² Ibid. S. 216

¹¹³ Ibid. S. 217

¹¹⁴ Ibid. S.219

- i. It is also a mandatory provision for every listed company to keep a register showing as respects each director, chief executive officer, managing agent, chief accountant, secretary or auditor etc, the number, description, and amount of any share, debenture of the company or any other subsidiary corporate body of the company or holding company.¹¹⁵
- j. Requirement from directors to disclose their shareholdings etc, and in the case they fail to do so, a punishment of imprisonment extendable to two years or/ and fine extendable to the extent of five thousand rupees to be imposed.¹¹⁶
- k. Duty of directors, chief executive, managing agent, chief accountant, secretary or auditor of a listed company and direct or indirect beneficial owner of more than ten percent securities to submit statements in prescribed forms to the register and the Commission stating the particulars regarding the beneficial ownership of such securities.¹¹⁷
- l. Short selling by director, chief executive, managing agent, chief accountant, secretary or auditor of a listed company and direct or indirect beneficial owner of more than ten percent securities has been debarred.¹¹⁸

(2) Sections aimed to ensure disclosure and fair accounts in corporations

¹¹⁵ Ibid. S. 220

¹¹⁶ Ibid. S. 221

¹¹⁷ Ibid. S. 222

¹¹⁸ Ibid. S. 223

The following are the provisions incorporated in the companies' ordinance 1984 to ensure disclosure and accounts such as:

- a. Proper books of accounts are required to be kept by all companies, inspection of those books is required from the registrar or any authorized officer and annual accounts and balance sheets along –final statements-required from the directors to lay them all before the general meeting of the company.¹¹⁹
- b. Besides the above provisions the accounting and reporting mechanism should comply with the international Best Practices of accounting and reporting. These International best practices are also adopted by the Institute of Chartered Accountants of Pakistan (ICAP).The Securities and Exchange Commission of Pakistan also perform an active monitory role. It has penalized nearly twenty five companies and has also imposed hundreds of actions in this regard.¹²⁰

All the above provisions incorporated in the companies' ordinance, 1984 are really playing a vital role in assuring best governance practices in the corporations, but still there are issues regarding the enforcement of some of the regulatory provisions, such as debarring loans to directors etc. Therefore the Securities and Exchange Commission of Pakistan is required to ensure that all the listed companies are abide by these provisions satisfactorily and that the gap between theory and practice of the companies has been eliminated.

¹¹⁹ Ibid. Ss. 230,233 and 234

¹²⁰ Asad Ali Shah "Accounting, Auditing and Governance Framework for Private Sector in, Pakistan" Presentation on February 15 2005 on Anti-Corruption Initiative for Asia-Pacific 3rd Master Training Seminar Organized by Deloitte Pakistan.p.29

2.8 National Accountability Ordinance 1999 (As modified up to 2010)

The National Accountability Ordinance (NAB Ordinance) initially issued in 1999 with certain modification up to 2010 provides for the establishment of National accountability Bureau. The aim of such a forum was to eradicate corruption and corrupt practices by public officers who misuse public money or misappropriate it.¹²¹ Section nine of this Ordinance defines the term “corruption and corrupt practices” as:

“(a) A holder of public office, or any other person, is said to commit or to have committed the offence of corruption and corruption practices¹²²

(i) If he accepts or obtains from any person or offers any gratification directly or indirectly, other than legal remuneration, as a motive or reward such as is specified in section 161 of the Pakistan Penal Code for doing or for-bearing to do any official act, or for showing or for-bearing to show, in the exercise of his official functions, favor or disfavor to any person, or for rendering or attempting to render any service or disservice to any person;¹²³ or

.....If he dishonestly or fraudulently misappropriates or otherwise converts for his own use, or for the use of any other person, any property entrusted to him, or under his control, or willfully allows any other person so to do¹²⁴ ...”

The definition of “person” extends “corruption and corrupt practices” to corporate frauds and misappropriations. Section five sub-section (O) defines the term “person” as:

¹²¹ See National Accountability Ordinance 1999 (modified up to 2010) preamble, p.01

¹²² Section 9 (a) National Accountability Ordinance 1999

¹²³ Ibid S.9 (i)

¹²⁴ Ibid (iii)

“includes in the case of a [company or a body corporate], the sponsors, Chairman, Chief Executive, Managing Director, elected Directors, by whatever name called, and guarantors of the company [or body corporate] or any one exercising direction or control of the affairs of such [company or a body corporate]; and in the case of any firm, partnership or sole proprietorship, the partners, proprietor or any person having [any] interest in the said firm, partnership or proprietorship concern or direction or control thereof”.¹²⁵ It means that corporate frauds and misappropriation of the capital or any other asset of the corporation also includes corruption and corrupt practices. Where the management of a corporation is found guilty of such a corruption or corrupt practices as a result of special prosecution before the Accountability courts, the management shall face the punishment of rigorous imprisonment which may extend to a term of fourteen years, payment of fine, and confiscation of misappropriated pecuniary resources and property obtained through corruption and corrupt practices.¹²⁶

Section 11 of the same Ordinance specifies the imposition of fine that it shall be equal to the gain derived by such person or any relative or his associate, through fraud, misappropriation, corruption or corrupt practices.¹²⁷ The Supreme Court of Pakistan has already considered an office in public company to be public office and has accepted

¹²⁵ Ibid S. 5 (O)

¹²⁶ Ibid S. 10 (a)

¹²⁷ Ibid S. 11

constitutional petitions for hearing in which the writ of *quo-warranto*¹²⁸ had been claimed.¹²⁹

National Accountability Ordinance is a milestone in Pakistan for the treatment of public officers and corporate management etc, to be prosecuted under the allegations of corruption and corrupt practices. All these provisions specifically control and stop the management, the sponsors of a body corporate or company, Chairman, Chief Executive Officer, Managing Directors, Elected Directors, and the guarantors of the company, from any misappropriation of money owned by the company or corporation, corruption and corrupt practices whatsoever.

2.9 Key Issues faced by Corporate Governance mechanism in Pakistan

Although the Pakistani corporate governance mechanism has delivered a satisfactory result, but still there are issues which have not been addressed by the companies ordinance, 1984. The monitory and enforcing role of Securities and Exchange Commission of Pakistan should be observed and felt as it is required in the favor of minority shareholders especially. These are pointed out as follows:

- a. Both the Companies Ordinance, 1984 and Code of Corporate Governance do not protect the minority shareholders having shares less than 10%. A

¹²⁸ *Quo-warranto* means a writ ordering a person to show by what right he exercises an office, franchise or privilege. Also termed writ of *quo-warranto*. See Concise Law Dictionary by Muhammad Abdul Basit Publisher (Federal Law House Islamabad). p.553

¹²⁹ See generally *Salahuddin v. Frontier Sugar Mills & Distillery Ltd.* PLD, 1975 SC 244. as quoted by Ali Adnan, Ibrahim in his paper " *Corporate Governance in Pakistan-Analysis of Current Challenges and Synopses for Future Reforms* ". p.6

complaint may only be filed in the court if 20% or more shareholders take initiatives against mismanagement for filing such a complaint in a civil court for tortious reward.¹³⁰ Thus there should be an internal mechanism in the company to protect the minority shareholders against the grievances caused by the management

- b. Conflict of Interest which causes fraud in the corporate culture (For example favoritism in awarding contracts and double book keeping to avoid taxes etc) is still needed to be addressed more affectively.¹³¹
- c. Lack of legal expertise in audit committee: The Security and Exchange Commission of Pakistan should incorporate the provisions binding on the listed companies to consider a professional lawyer or (legal advisor¹³²) as an independent, non-executive director. The so composed audit committee should certify company's compliance with the applicable laws, and resolve the problems of minority shareholders using its legal expertise.¹³³
- d. Lack of ethical standards: The companies in Pakistan do not comply with the ethical standards in their practical activities. Thus detailed ethical standards should be formulated by the security and exchange commission of Pakistan and all the companies should be asked to comply with those ethical standards.

¹³⁰ Op.cit, S.290 of the Companies Ordinance 1984

¹³¹ Op.cit, Asad Ali Shah "Accounting, Auditing and Governance Framework for Private Sector in, Pakistan" Presentation on February 15 2005, p.35

¹³² This Legal advisor is appointed pursuant to the provisions of (Appointment of Legal Advisors Act) and is suggested, for the purpose of ensuring the legal expertise of the audit committee, to be nominated as a non-executive director

¹³³ Op.cit, Adnan, Ibrahim "Corporate Governance in Pakistan-Analysis of Current Challenges and Synopses for Future Reforms", Pp,330.331

The security and exchange commission of Pakistan is expected hopefully to address these loopholes and play a role for the protection of the interests of stakeholders, especially minority shareholders, because the protection of their interests is not covered to a great extent by the governing provisions of the statutes.

2.10 Business Principles and SECP Code of Corporate Governance

Islam deals with the *Muamalat* (transactions) in a different way from *Ibadat* (devotional acts). The *Shariah* has prescribed general principles to be followed in *muamalat* (transactions) and guidance may be sought by different people at different places in different times. Specific rules may be designed by Muslim jurists for *muamalat* (transactions) which may be considered essential under the prevailing situations. *Shariah* has provided masses a sort of freedom in their dealings and entering into transactions. Considering this special kind of treatment of the *muamalat* in Islamic law the general business principles are summarized as follows:¹³⁴

1. A business contract/ transition should be concluded by free mutual consent of both the contracting parties
2. The contract should be free from *gharar* (Uncertainty, indeterminacy)
3. The element of *Riba* (Usury) should be removed, if there is any
4. It should be free from *ghishsh* (Fraud) and *Khilabah* (deception/ cheating)

¹³⁴ Op.cit Tahir Mansoori, Muhammad "Islamic Law of business contracts and Business transactions" 3rd Edition 2005 Publisher (Shariah Academy International Islamic University Islamabad). p.4

5. There is no permissibility of two mutually inconsistent contracts in Islam
6. A contract should not be contrary to *Maqasid Al Shariah* (Objectives of *Shariah*)¹³⁵
7. The contract must confirm the principle of liability for Loss and Entitlement to Profit and
8. The principle of general permissibility. That what is not explicitly prohibited by the Law giver is permissible. Means all the agreements and contracts are permissible until and unless they are repugnant to any explicit text of the *Qur'an* or *Sunnah* or oppose the objectives of *Shariah*¹³⁶

Hence the corporations are running different sort of business, therefore these general principles of business are needed to be followed by the Pakistani corporations especially. The reason is that Pakistan's Constitution mentioned in article 2-A, that the lives of Muslims shall be fully confirming the directions set out in the Holy *Qur'an* and *Sunnah*. Article 2-A and article 227 (1) of the Constitution of Islamic Republic of Pakistan 1973 explicitly require the incorporation of Islam into the constitution. The text of both the articles is reproduced here for the better understanding of the fact. Article 2-A states:

“Wherein the principles of democracy, freedom, equality, tolerance, and social justice as enunciated by Islam shall be fully observed; Wherein the Muslims shall

¹³⁵These objectives are: Preservation of religion, Preservation of life, Preservation of Progeny, Preservation of Intellect and Preservation of Property

¹³⁶ See Dr. Muhammad Tahir Mansoori on ““*Islamic Law of business contracts and Business transactions*” 3rd Edition Chapter 1

enabled to order their lives in the individual and collective spheres in accordance with the teachings and requirements of Islam as set out in the Holy *Qur'an* and the *Sunnah*.¹³⁷

Article 227 (1) of the same Constitution states:

“All existing laws shall be brought in conformity with the Injunctions of Islam as laid down in the Holy *Qur'an* and *Sunnah*, in this Part referred to as the Injunctions of Islam, and no law shall be enacted which is repugnant to such Injunctions.”¹³⁸

Hence the Constitution of Pakistan is the fountain of all other Laws whether those are bye-laws of the organizations, business corporations, and other entities or laws passed by the legislature or parliament, all of them are subordinate laws and are required to strictly confirm the principles and provisions envisaged in the constitution. According to my humble opinion, the Security and Exchange Commission of Pakistan which enacted the Pakistani code of corporate governance is required to insert the above mentioned business principles in the code and direct all the listing companies to strictly follow these general principles. This will lead the corporations to ensure good governance practices according to the spirit of Islam.

Although Securities and Exchange Commission of Pakistan considers that the desired way for the promotion of the interests of all the stakeholders is to ensure that the business is run and the corporations are managed in accordance with the highest prevailing standards of ethics.¹³⁹ But the issue here is that the whether the “high ethics” are in conformity with the business principles and rules laid down by Islam or not? The

¹³⁷ Constitution of the Islamic Republic of Pakistan 1973 Annex, Part 1 (Introductory) Article 2-A

¹³⁸ Ibid Part IX Islamic Provisions

¹³⁹ Op.cit Securities & Exchange Commission of Pakistan “*Manual of Corporate Governance*” Paragraph 2.1

position of Security and Exchange Commission of Pakistan is ambiguous here, whether the duties assigned to it are based on common law or purely on Islamic Law. The business ethics for the corporate governance in Pakistan are seriously required to be based on those prescribed by Islam and the gap between theory and practice of the corporate entities must be eliminated in this regard.

CHAPTER 3

CORPORATE GOVERNANCE FROM *SHARIAH* PERSPECTIVE

Islamic Financial Industry is an integral part of the international financial system, and it is essential for its compliance with the principles of Islamic Law to adopt *Shariah* Governance, which regulates the economic activates of this industry. The business activities of Corporations are needed to be free of forbidden dealings to get the satisfaction of Muslim shareholders of their compliance with the principles of Islamic Law.

In Islamic Financial Industry, *Shariah* governance mainly aims to regulate the affairs of management and establishment of the *Shariah supervisory* board according to the spirit of *Shariah*. The said board normally comprises of *Sahariah* Scholars and academicians, and is an independent body of Scholars, whose duty is to direct, review and supervise the activities of Islamic financial industry for the purpose of their compliance with *Shariah* and to issue *Shariah* rulings related to Islamic finance.¹⁴⁰

3.1 Defining Corporate Governance in *Shariah*

Besides the definitions mentioned in the first chapter, *Shariah* Scholars have also defined the term” Corporate governance “as it is not alien to Islam. Generally if we observe, the corporate governance is carrying a great significance for the Islamic Financial Industry .This industry is being counted a major source of business activities

¹⁴⁰See <http://www.hawkamah.org> See *Hawkamah* newsletter Issue 10 volume 1 p.2 visited on 26.12.2009 AT 04 PM

and investment projects worldwide, and its transactions are reaching more than a trillion dollar. Islamic Financial Institutions provide a choice to the investors and savers who need to deal with exclusively Islamic financial transactions rather than conventional.

According to *Shariah* Scholars, the goal of corporate governance “is to ensure ‘fairness to all stake holders to be attained through greater transparency and accountability. The secular governance practices are not relevant for the transaction that a firm would do in the ordinary course of business (except for the related party, self-dealing etc transactions) But *Shariah* would first look at the transactional structure to see whether the transaction involves elements that invalidate the gains or profits. The conventional corporate law performs the similar function and to ensure that the corporate transactions do not cross the limits of the corporate charter or cross the lines drawn by the law”¹⁴¹.

In my opinion a codification is required which shall essentially declare a non-*Shariah* business or transaction to be illegal in the eye of *Shariah*. In the absence of such codification the role of *Shariah* governance will become more vital and significant for the revision of corporation’s transactional conformity with the principles of *Shariah*.

The term” corporate governance” could be a modern conceptual creation. The principles, norms and values that are associated to this concept are not alien to *Shariah*. Islam has been prescribed as a comprehensive way of life and that Islam has always emphasized on good ethics, strong moral values, integrity, honesty and trustworthiness of the highest degree. Those who propose good governance consider that the separation of ownership and management of a corporation may lead to agency problem and in their

¹⁴¹ Ali Adnan Ibrahim “*Convergence of corporate governance and Islamic Financial Services Industry towards Islamic Financial Services Securities Market*” Paper 3. Published in 2006 p.10

view it has been addressed in the Holy *Qur'an*, which reflects the significance of ethics not only in contracts and dealings but also in accountability to Allah (S.W.T).¹⁴² The code of ethics that has been mentioned in the Holy *Qur'an* consists of the following:

a. Honest fulfillment of contacts-

Allah (S.W.T) addressed muslims in the Holy *Qur'an* as:

” O ye who believe! Fulfill all obligations”¹⁴³

b. Prohibition of treachery to trust-

“O ye who believe! Betray not the trust of Allah (S.W.T) and the Messenger, nor misappropriate knowingly things entrusted to you.”¹⁴⁴

c. Prohibition of earning the wealth by way of cheating , hoarding dishonesty or fraud-

“O ye who believe! Eat not up your trade by mutual goodwill, nor kill (or destroy) yourselves; for verily Allah (S.W.T) hath been property among yourselves in vanities. But let there be amongst you traffic and to you Most Merciful!”,¹⁴⁵

d. Prohibition of bribery to get undue advantage-

“And do not eat up your property among yourselves for vanities, nor use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people’s property.”¹⁴⁶ And

a. Emphasize on minimizing problems between contracting parties-

¹⁴² Islamic financial services Board “*Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial services(Excluding Islamic Insurance Institutions and Islamic Mutual Funds)*” Exposure Draft No.3 Publisher (IIFSB Kuala Lumpur Malaysia.) December 2005 p.16

¹⁴³ *Qur'an* 5: 1

¹⁴⁴ *Qur'an* 8: 27

¹⁴⁵ *Qur'an* 4:29

¹⁴⁶ *Qur'an* 2:188

“....Disdain not to reduce to writing (your contract) for a future period, whether it be small or big; it is jester in the sight of Allah. More suitable as evidence and more convenient to prevent doubts among yourselves...”¹⁴⁷

3.2 The Objectives of Islamic Corporate Governance

As I have discussed before that *Shariah* governance is the name of ways as to how the *Shariah* board is directed, managed governed and controlled. These set of organizational arrangements definitely ensures a *Shariah* compliant structure and framework for governance practices which are in line with the principles of *Shariah*. The importance of corporate governance has been recognized by all the financial systems, including Islamic Economic System therefore one can say that Islam has never been alien to corporate governance and has recognized its importance. The following are the main objectives of Islamic corporate governance due to which it becomes so important for business entities and organizations.

1. Islamic corporate governance aims to ensure the exercise of paramount principles of accountability, strict auditing, large amount of transparency and more rights for minority shareholders in a corporation.
2. Islamic corporate governance ensures prevention of *gharar* (risk, uncertainty and hazard) and avoids business transactions cause injustice to any of the contracting parties.

¹⁴⁷ Qur'an 2: 282

3. *Shariah* governance aims to ensure the *Shariah* compliance of financial transactions and business activities so as to maintain the integrity of Islamic economic system as desired by the concerned stakeholders.¹⁴⁸
4. Islamic corporate governance also aims to replace the criterion of maximization of profit for the organization and shareholders with social welfare by ensuring unity between the corporation and shareholders and the social and economic factors.¹⁴⁹

The mere purpose of Islamic corporate governance is to ensure that the corporation is run according to the welfare of shareholders, organization and society at large. The well of Allah (S.W.T) is not violated and the business activities of the organization are controlled in compliance with the Islamic guidelines.

3.3 The associated values of corporate governance

According to Muhammad Asri and Muhammad Fahmi-the authors of research article “*Contribution of the Islamic worldview towards Corporate Governance*”- there are four values, which have a strong relation with the corporate governance. These values are:

- b. *Shariah* Audit
- c. Accountability
- d. Transparency and
- e. Trustworthiness

¹⁴⁸ Hani, Kablawi “*improving Corporate Governance in Islamic finance*” Innovation Series Research Paper, Global Corporate Trust Publisher (The Bank of New York Mellon.) 2008 ,p.3

¹⁴⁹ Alam Choudhury Masud, Ziaulhaque Mohammad “*Corporate Governance in Islamic Perspective*” Research Paper volume 6 No 22006 Publisher (Emerald Group Publishing Limited ISSN 1472-07701

The authors believe that these concepts are derived from the Islamic worldview.¹⁵⁰ They have also elaborated all of them in quite depth, to which I shall refer in the coming pages.

3.4 *Shariah* Audit

In this part of the chapter, the role of *Shariah* Audit will be discussed. *Shariah* Audit is one among the basic elements of corporate governance, because it provides for the performance monitoring in accordance with the *Shariah* compliant policies made in the interest of organization and stakeholders. It is pertinent to mention the role of internal audit (IA) or *Shariah* auditing or internal *Shariah* auditing (ISA) here, because the governance system of the corporations is discussed from Islamic perspective.

3.4.1 *Shariah* Audit defined

The lack of literature on the subject under discussion, there is no definition of the term “*Shariah* audit” unanimously agreed upon. The present writings on the subject use the term synonyms to the term “*Shariah* review”. The Auditing and Accounting Organization for Islamic Financial Institutions (AAOIFI’s) defines the term “*Shariah* review”, in the standard related to governance, which is considered the most reflective definition that is as given below:¹⁵¹

“*Shariah* review is an examination of the extent of an IFI’s compliance, in all its activities with the *Shariah*. This examination includes contracts agreements, policies,

¹⁵⁰ Asri Mohammad, Fahmi Mohammad “Contribution of the Islamic Worldview towards Corporate Governance” p.4 <http://www.iiu.edu.my/.../Asri%20and%20Fahmi%20IslWWandCG.htm> – Last Accessed on 12/05/2009 AT 05:00 PM

¹⁵¹ Sultan Muhammad, Alwi Syed “A Mini Guide to *Shariah* Audit for Islamic Financial Institutions – A Primer”. Publisher (CERT Publications Sdn Bhd, Kuala Lumpur Malaysia) 2007. p.6

memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc".¹⁵²

Syed Alwi Muhammad Sultan has analyzed the above definition in his book "A Mini Guide to *Shariah* Audit for Islamic Financial Institutions - A Primer". He mentions that this definition lacks the areas of the information technology for supporting the banking operation, the structure of the organization, processes and the marketing staff of an Islamic financial institution. He suggests that these areas should also be the subject of *Shariah* audit because these are risk areas of the Islamic financial Institution as well. The author proposes a general and comprehensive definition as following:¹⁵³

"*Shariah* audit is the examination of an IFI's compliance with the *Shariah*, in all its activities particularly the financial statements and other operational components of the IFI that are subjected to the risk of compliance including but not limited to products, the technology supporting the operations, operational processes, the people involved in key areas of the risk, documentations and contracts, policies, and procedures and other activities that requires adherence to *Shariah* principles."

The above mentioned definition may be considered a comprehensive one, as it covers all the potentially risk areas which must be subjected to religious audit. In this way the company will be able to strictly adhere to Islamic norms in all its operations for achieving the goal of company's interest and other stakeholders in general.

¹⁵² Accounting and Auditing Organization for Islamic Financial Institutions "Governance Standards of Islamic Financial Institutions No 2:Shariah Review" Publisher (AAOIFI) 2001,p.17

¹⁵³ Op.Cit, p.8

3.4.2 The early Islamic history of auditing

The early Islamic history regarding the subject under discussion shows that the institution of *Hisbah* and the role of *Muhtasib* for monitoring, regulating and ensuring fair market practices goes back to the era of (S.A.W) (S.A.W) and His four Caliphs. This role was based on the Verse of the Holy *Qur'an* which emphasizes on Muslims to command for right and prevent wrong. Like the Verse states:

“Let there arise from you a group calling to all that is good, enjoining what is right and forbidding what is wrong. It is these who are successful”¹⁵⁴

Imam *Ghazali*- as quoted by Dr.Nawal Kasim¹⁵⁵ is of the view that the practices of *Hisbah* must be observed from every one among Muslims as *fard kifayah*, so that every Muslim has to play the role of *Muhtasib*-Promoting the right and preventing what is bad-. He has the duty of promoting *maruf* (good) and suppressing of *munkar* (evil). However, it is the duty of a part of society to remain engaged in doing so. The *Muhtasib* is a person who is given the authority by the state to implement *Hisbah*.¹⁵⁶

The Institution of *Hisbah* also moved to the Islamic province of Spain and remained an integral part of the state's institutions, but unfortunately with the strength of colonialism, like the other Islamic institutions, this institution also declined and ultimately disappeared. As long as the Institution of *Hisbah* was strong and effectively working, the governance system was also strong and affective.¹⁵⁷ The reason behind this was that the institution of *Hisbah* was given the mandate to implement the golden

¹⁵⁴ *Qur'an* 5:104

¹⁵⁵ Dr.Nawal Kasim is a senior lecturer in the Faculty of Accountancy University of Technology MARA, Shah Alam- Selangor, ,Malaysia

¹⁵⁶ Dr.Nawal Kasim “Auditing from the Islamic Perspective” Research Article, p.3; Also available online on <http://www.mia.org.my/at/at/2010/06/08.pdf> Last Visited on 30/07/2010 at 10:52 PM

¹⁵⁷ *Ibid*

principles of fair business dealings and market practices. In the case of any violation of those principles, *Muhtasib* was given the authority to implement the procedure and award punishments to all the violators of those principles.

The functions of the auditor are vital in a sense that he is not only accountable to those who have concern with the financial statements of the organization, but to Allah (S.W.T) as well. The reason is that Allah (S.W.T) is always watching being a (*Muraqib*) all the deeds of Muslims. Allah (S.W.T) has clearly mentioned this fact in the Holy Qur'an in the following words:

“...Surely Allah (S.W.T) takes the account of all things.”¹⁵⁸

The word “account” in this Verse refers to accountability of every Muslim to God for all the activities.¹⁵⁹

3.4.3 The Objectives of *Shariah* Audit

Islam clearly points out the differences between Islamic and western business principles, like the *Shariah* prohibits usurious transactions, gambling, hoarding, speculation, dealing in alcohol, pork, and other things which are unlawful in Islam. Religious or *Shariah* audit is therefore essential for making it sure that the organization is fully run in compliance with the *Shariah*. In the case where *Shariah* auditors find any infringement of the Islamic business principles in the activities of organization, then this should be reported in the financial statement which is to be made available to all the users.¹⁶⁰

¹⁵⁸ Qur'an 4:86

¹⁵⁹ Op. Cit p.4

¹⁶⁰ Asri Mohammad, Fahmi Mohammad "Contribution of the Islamic Worldview towards Corporate Governance" 2008, p.15

Some of the finance scholars such as Briston and El-Ashker say that there are three main objectives of the *Shariah* auditing as following:

1. Ex- ante auditing: to advise the board of directors and managing director about the conformity of contracts and procedures with the Islamic principles, and this is the duty of *Shariah* Supervisory Board
2. Ex-post auditing: to check whether the executive management has acted upon the advice of *Shariah* Supervisory Board in compliance with the Islamic code and
3. Islamic tax auditing: to make it sure that whether that zakah on the business assets is calculated and distributed among the needy persons.¹⁶¹

3.4.4 AAOIFI Governance Standard on *Shariah* Auditing

The auditing standards number one and four for Islamic financial institutions which has been issued for achieving the goal of business conformity with the rules laid down by Islam for conducting business activities.

The auditing standard No 1 has discussed the objectives of audit in general as:

The aim of an audit is to enable the auditor to express his true and fair opinion regarding the conformity of financial statements with the *Shariah* rules and principles, the accounting standards of the Accounting and Auditing Organizations and relevant Accounting standards of the concerned country where Islamic financial institute

¹⁶¹ Bakhtiar Ahmed, Nazli Mohammad "Islamic Worldview and Effective Corporate Governance" Research article online source www.iiu.edu.my/.../Islamic_Worldview_Effective_Corporate_Governance_BahkandNazli.doc -p.33 Last Visited on 31/07/2009 At 12:05 AM

operates.¹⁶² The role of auditor is vital and requires the highest degree of integrity and honesty. The general principles of auditing require from an auditor to comply with the code of ethics and ethical principles which are necessary for the professional responsibilities of an auditor. These governing principles are also considered the components of *Shariah* audit such as:¹⁶³

- a) Righteousness
- b) Integrity
- c) Trustworthiness
- d) Fairness
- e) Honesty
- f) Independence
- g) Objectivity
- h) Professional competence
- i) Due care
- j) Confidentiality
- k) Professional behavior and
- l) Technical standards

¹⁶² Accounting and Auditing Organization for Islamic Financial Institutions “*Auditing Standard for Islamic Financial Institutions No.1: Objectives and Principles of Auditing*” issued by AAOIFI Bahrain, 2001, p.5

¹⁶³ Ibid

3.4.5 AAOIFI Auditing Standard and the responsibility of external auditor

The auditing standard No.4 has laid down that the external auditor is responsible to express his fair and true opinion on the conformity of financial statements with the rules of *Shariah* and principles determined by the *Shariah* Supervisory Board (SSB) as prescribed by auditing standard NO.1 and 2. The external auditor must be knowledgeable with the Islamic rules and principles and the *fatawas*, rulings and guidance issued by the *Shariah* Supervisory Board shall be considered by him in testing for compliance with the rules of *Shariah*.¹⁶⁴

The responsibility of an auditor does not extend to assess the competence of the *Shariah* Board's members but he has to satisfy himself that all the activities, new products, modified products and the transactions are in conformity with the *fatawas* and ruling. The review of the findings of all internal reviews carried out by the management of Islamic Financial Institution, the internal audit and internal *Shariah* review also includes his responsibilities.¹⁶⁵

3.4.6 The functions of Internal Audit and Internal *Shariah* Audit

The duty of internal audit is ensure that the internal control system of organization is working and the management is also adherent to the procedures which have been made for managing the capital and business. Any new findings should be communicated to the audit committee. Internal audit has to focus on the operation and financial aspects of the

¹⁶⁴ Accounting and Auditing Organization for Islamic Financial Institutions "Auditing Standard for Islamic Financial Institutions No.4: Testing for Compliance with Shariah Rules and Principles by an External Auditor" issued by AAOIFI Bahrain, 2001, Pp,43,44

¹⁶⁵ Ibid,p.44

business, while Internal *Shariah* Audit will keep an eye on the compliance of the corporation's activities. Internal Audit is a normal concept in the contemporary corporate practices, but Internal *Shariah* Audit provides for monitoring the business compliance with the principles of *Shariah*.¹⁶⁶

The AAOIFI standard on Governance for Islamic Financial Institutions number three has also mentioned four functions of internal *Shariah* auditing in the following words.¹⁶⁷

The functions of internal *Shariah* auditing will be:

1. To review procedures planning: obtaining the relevant information, establishment of objectives and the importance of work, getting *Shariah* Supervisory Board *fatwas* findings , last year's reports;
2. Implementation of review procedures, preparation and review of working papers: Like the collection, analysis, interpretation, documentation of information relevant to the Internal *Shariah* Review findings and preparation of working papers which document the review in a complete and organized shape to be reviewed by the Head of Internal *Shariah* Audit
3. performing follow-up in any results during the performance of any tasks
4. Report's and conclusion's documentation¹⁶⁸

To conclude the subject under discussion, it is derived from the above mentioned function of the *Shariah* audit, that auditing here refers to the duties of auditors to keep an eye on the processes of business of the corporation for their compliance with Islamic

¹⁶⁶ Op.Cit Bakhtiar Ahmed, Nazli Mohammad "Islamic Worldview and Effective Corporate Governance" Research article online source www.iiu.edu.my/.../Islamic_Worldview_Effective_Corporate_Governance_Bahkand_Nazli.doc - Last Visited on 31/07/2009 At 12:50 AM ,p.34

¹⁶⁷ Ibid

¹⁶⁸ Ibid

code(Islamic business principles).The *Shariah* supervisory board ,the internal *Shariah* auditors/religious auditors have to be vigilant about their functions in this regard, because their positive and effective role will provide for a better *Shariah* governance of an organization. Ultimately, the needs of all the stakeholders¹⁶⁹ will be satisfied and the principles of Islam will be followed, and this will lead for success (*Falah*) in this world and in hereinafter (*Akhira*)

3.5 Accountability: The 2nd pillar of *Shariah* Corporate governance

Accountability is also a basic element of good governance, because it is essential to relate the activities of authority holders to community and God. *Shariah* is the leading force for all Muslims as it consists of all aspects of human life which includes their socio-economic dealings. Ultimately every Muslim is accountable to Allah (S.W.T) for his/her deeds as prescribed by the Holy *Qur'an*:¹⁷⁰

“To Allah (S.W.T) belongeth all that is in the heavens and on the earth, whether ye show what is in your minds or conceal it. Allah (S.W.T) calleth you to account for it.”¹⁷¹

Another Verse of the Holy *Qur'an* denotes the notion of accountability in the following words:

“And fear the Day ye shall be brought back to God; then shall every soul be paid what it earned, and none will be dealt with unjustly.”¹⁷²

¹⁶⁹ The term” stake holders “includes the share holders, suppliers, customers, the community at large and staff of the corporation. See “*Corporate truth: the limits to transparency*” by Adrian Henriques Publisher (Earthscan, UK) 2007, p. 39

¹⁷⁰ Iqbal Zafar, Lewis Marvyn K “*An Islamic Perspective on Governance: new*” Publisher (Edward Elgar Publishing Ltd Heatherley House U) 2009 p.256

¹⁷¹ Qur'an 2:284

¹⁷² Qur'an 2:281

This Verse of the Holy *Qur'an* is evident that accountability to Allah (S.W.T) and the community for all activities has a significant place in Islam. Obviously, accountability is not limited to Muslims and applies to all aspects of life and all communities. Those who have charge of economic resources must give accounts of their actions, irrespective of whether their actions and the resources are of a private enterprise or a government enterprise. This is a function has been a regular practice of organized human activity for a long time. Accountability has broader and vast socio-economic objectives and no more than which it has in *Shariah* in which economic, political, religious and social matters collectively fall under the legal system of the divine law of Islam. The Holy *Qur'an* and *Sunnah* clearly mention what is true, fair and just, what are the priorities of society, what is the role of individuals and business firms and what are the ways by which their activities are to be governed.¹⁷³

3.5.1 Western corporate accountability and the modern Muslim Scholars

An Islamic corporate governance design denotes the promotion of broad ethical and social concerns through the establishment of accountable corporations. The main aim is to ensure the righteous behavior and to forbid immoral conduct in the broad social concern inside corporate culture. Their public obligations cover religious activities, communal affairs, and the encouragement of moral ethical behavior in business activities.

¹⁷³ Op.cit

The western Scholars may observe some sort of confusion between Private dealings and Public dealings, but Islam deals with humanity and human affairs generally in total.¹⁷⁴

Some modern Muslim Scholars have asked for the application of the broader Idea of accountability rather than that of the specific duty of directors to be accountable to minority and majority shareholders. The modern western accountability makes someone answerable for the outputs of corporation only. Such a concept of accountability provides that the directors are accountable to shareholders for monitoring the business dealings. Many modern commentators have argued that in some situations the directors should be accountable to potential and prospective shareholders as well.¹⁷⁵ Some others argue that this duty extends even further, because in their view the modern corporation affects the lives of many members of the society, so therefore it should be accountable to each of the members of the society to employees (that their employment should be continued), to customers (their rights should be preserved throughout the life of product). It should be also be accountable to suppliers, should be accountable for the environmental and social matters and to the society at large for it's economic welfare.¹⁷⁶

The concept of corporate accountability intermingles with those of *Tawhid*, *Khilafah* and *Takilf* (that every person is accountable for his own deeds) on one hand .On the other hand, it requires proper bookkeeping .There must be commitment in compliance and control. The person or entity involved must consider and accept that accountability is

¹⁷⁴ Rahim Abdul, Rahman Abdul “ *Issues in Corporate Accountability and Governance: An Islamic Perspective* ” The American Journal of Islamic Social Sciences, Publisher (Association of Muslim Social Scientists north America) p. 66

¹⁷⁵ Abdul-Rahim, Abdul-Rahman “ *Issues in Corporate Accountability and Governance: An Islamic Perspective* ” The American Journal of Islamic Social Sciences, Publisher (Association of Muslim Social Scientists north America) p.67

¹⁷⁶ Ibid

his or its obligation and duty.¹⁷⁷ The discussion about corporate accountability and corporate governance is in need to be started on values and not on standards and rules. This is not sufficient to say that this is the culture or way for the commencement of business, but the question is that whether what business does is right or wrong?

The review of Islamic institutions is evident that new parameters are required to be considered by the modern corporate regulators for the implementation of a sound and perfect accountability in corporations. There is severe need for the consideration of Islamic institutions, like, *Shura* and *Shariah Audit* with some new adaptations required for the present corporate environment.¹⁷⁸

3.5.2 Accountability in *Qur'an* and *Sunnah*

In the Holy *Qur'an* the word *Hesab* has been mentioned in more than eight places in various verses. The word *Hesab* or 'account' is the base for accounting. When this word is referred to in the Holy *Qur'an*, means 'account' in its real sense, which represents the one's obligation to be accountable to Allah (S.W.T) on all activities pertaining to man kind's endeavor for which every one among us is 'accountable'. Thus there is a similarity between *Hesab* in Islam and accounting as every Muslim is responsible to carry out his work as described in the Holy *Qur'an*. Similarly, in a business organization, management and the capital providers both are accountable for their activities within and outside the firm or business enterprise. In this context, accountability means accountability to the society at large or *Ummah*. The actions of

¹⁷⁷ Ibid

¹⁷⁸ Ibid p.68

Muslims are always bound by *Shariah* and there is no room for splitting their behavior into religious and secular behavior.¹⁷⁹

It has been emphasized in a number of Verses and traditions of the Holy Prophet (S.A.W), that every Muslim individual should enjoin *Maaruf* and forbid *Munkar*. The Holy Proph (S.A.W) stated:

“By Him in whose had is my soul, you must enjoin the *Maaruf* and forbid the *Munkar*, otherwise Allah (S.W.T) will be about to send His punishment upon you. And then if you pray to Him (to ask Him), He would not answer you.”¹⁸⁰

The above tradition of the Holy Prophet (S.A.W) carries the meaning that every Muslim is a guardian and is accountable to God for the actions of his subordinates. This has been stated by The Messenger of Allah (S.W.T) as follows:

“Each one of you is a guardian and each guardian is accountable to everything under his care...”¹⁸¹

To relate the Idea of the Islamic concept of accountability with the system of corporate governance, it can be stated in the light of the above discussion that all the stakeholders of a corporation for example, the directors, managers as well as the auditors must perform their duties in a professional way keeping in their minds that they have to satisfy the requirements of the investors and Allah (S.W.T). Malaise like fraud, material misstatement, should be avoided. If this concept of *Shariah* could be exercised could be observed in the performance of their professional duties, the aim of *Shariah* corporate governance can be achieved to a great satisfactory extent. But it is their bad luck that

¹⁷⁹ Lewis K Marvin “*Accountability and Islam*” a research paper presented at fourth International Conference on Accounting and Finance in Transition Adelaide. April 2006 p.2

¹⁸⁰ Bin Hanbal-Ahmed “*Musnad Ahmad*” on the Authority of Huzyfah volume,4, Tradition Number 2169,

¹⁸¹ Ibne-Isamil,Muhammad Al-bukhari “*Sahi'h Al-Bukhai*” Tradition No 2278

most of these stakeholders have been intoxicated with the materialistic worldly benefit which leads them all to an unjust conduct resulting in the injury caused to the owners(shareholder) of the corporation.¹⁸²

The conclusion withdrawn here from the writings of modern Scholars and classical *Shariah* Jurists is that, *Ihtisaab* (Self accountability), (the duty of every Muslim to command good and forbid wrong) and accountability are interlinked with each other, and there is a relation among all these, considering them the values of *Shariah* Corporate governance. If all the principles and rules mentioned above will be followed by all the stakeholders and they will carry on their duties in a professional manner then it shall lead to better *Shariah* governance according to the Islamic financial rules and principles.

3.6 Transparency (*Al-Shafafiyah*) and corporate governance: An Islamic Perspective

Before going in details of this value of corporate governance, it is pertinent to mention that this principle or value has a deep relation with the prior one-Accountability. The reason is that the application of accountability, *Ihtisaab*, and *Hisbah* all provide a base for transparency in a corporation.

The concept of transparency is derived from the following Verse of the Holy *Qur'an*:

“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...”¹⁸³

¹⁸² Op.cit, Asri Mohammad, Fahmi Mohammad "Contribution of the Islamic Worldview towards Corporate Governance" 2008 p.5

¹⁸³ Qur'an 2:282

The above mentioned Verse emphasizes on writing down the transactions, so that the parties involved will avoid any future dispute and litigation this way.¹⁸⁴

In Islamic economy, it is accountability which delivers a true, fair and transparent disclosure. As a result a fair and true transparency is observed in Islamic financial Industry in general. For ensuring transparency all the stakeholders of the company must be accountable first of all to Allah. As I have mentioned already that the basic concept of Islamic accountability is believed that all available resources is merely the ownership of Allah (S.W.T) and the individuals have been entrusted with them. Therefore, the transparent disclosure of financial facts, dealings should be made accessible to the users and the accurate Information about those facts and dealing should also be made available to them freely.¹⁸⁵

Another important thing involved here is that all the users must be adequately informed and this is needed for smooth and sound financial decisions. This will cause for the payment of *Zakah* which is the third pillar of Islam. Transparency here involves the aspects of:

- a. Accuracy in the disclosure of financial statements
- b. Fairness
- c. Equality in distribution of wealth, and
- d. Just system

¹⁸⁴ See Bakhtiar Ahmed, Nazli Mohammad on "Islamic Worldview and Effective Corporate Governance" p.5 Research article http://www.iiu.edu.my/.../IslamicWorldview_EffectiveCorporateGovernance_BahkandNazli.doc Last Visited on 30/07/2010 at 08:33 AM

¹⁸⁵ Asri Mohammad, Fahmi Mohammad "Contribution of the Islamic Worldview towards Corporate Governance" p.8 <http://www.iiu.edu.my/.../Asri%20and%20Fahmi%20IslWWandCG.htm> – Last Accessed on 12/11/2009 AT 05:40 PM Pp.8, 9

All the above elements are necessary to be observed for making consistent economic and business decisions. It can also be said that transparency and disclosure are fundamental strong ethics in Islamic corporate mechanism and they help in the improvement of a better *Shariah* corporate governance system.¹⁸⁶

The equal and just distribution of wealth among all the stakeholders and other needy members of the society in the form of *Zakah* and *Sadaqah* is one of the core principles of Islamic economic system which is ensured only through the application of transparency and disclosure in the financial institutions. It is pertinent to mention that the needy members of Muslim society are also reckoned as stakeholders of corporation, as the corporation's assets are required to be purified through the payment of *Zakat* and *Sadaqat* to all the needy members of the society. The presence of transparency in a company leads all the stakeholders to *Falah* (Success in this world and in hereinafter) and social welfare motives. The orientation to avoid *Haram* is also be ensured through the observance of transparency and disclosure in the company.¹⁸⁷

Transparency in business denotes that then full and accurate information must be made available to the users and the details about business transactions and dealing must be present in correctly and fully. The Holy *Qur'an* has also a concern with this matter, for example it is mentioned in the Holy *Qur'an* that: "... give full measure...."¹⁸⁸. True disclosure of financial dealings and the relevant facts, their proof without any cheating, fraud or malice for the satisfaction of user's requirements, is very much necessary for the

¹⁸⁶ Ibid

¹⁸⁷ Ibid p.11

¹⁸⁸ *Qur'an* 11:281

fulfillment of such duties and facilitation of decision making on business and investment.¹⁸⁹

The Muslim commentators and financial experts some are of the view that Islamic corporate governance framework must be stood on some basic pillars, among those one must be transparency. It is stressed by them that the observance of transparency must be ensured and it should be guided by the principles of *Shariah*. In this case the system of corporate governance would be more fruitful for regulating the relations among all stakeholders on a just, equal and fair basis.¹⁹⁰

3.6.1 Islamic Financial Industry (IFI) and Transparency

The Islamic Financial Services Board has brought a number of drafts mentions some principles in its exposure draft “Guiding Principles on *Shariah* Governance System”. These guiding principles strengthen those codes of business conduct which are essentially imposed on entities licensed by regulators in various countries. We will mention here only those principles which have concern with Transparency in business, to avoid lengthy details. The principles mentioned in this exposure draft regarding fairness and transparency provide that:¹⁹¹

- a. The Islamic financial Services Industry shall ensure the highest degree of truthfulness, fairness and honesty in all its financial statements, business dealing and must treat its customers justly and fairly. It suggests that an Islamic Financial Industry

¹⁸⁹ Marven K, Lewis “*Accountability and Islam*” a research paper presented at fourth International Conference on Accounting and Finance in Transition Adelaide. April 2006 p.10

¹⁹⁰ Asfandyar Malekian , Abbas Ali Daryayi “*Islamic values forward into better corporate governance systems*” research article Publisher (global research agency Selangor Malaysia) p.9

¹⁹¹ Islamic Financial Services Board “*Draft Guiding Principles on Shariah Governance System*” Publisher (IFSB publishing Kuala Lumpur Malaysia) April 2009 p.1,2

should neither intentionally or negligently provide any information which misleads the stakeholders or the market regarding any product or deal having concern with its legality in the eyes of *Shariah*.

- b. There must be steps taken by an IFSI to understand the circumstances and nature of its customers for offering them suitable products and financing them merely for those projects which don't violate the principles of *Shariah*. This principle can be termed as the principle of "know your customer (KYC)" and it is well known in the banking sector.
- c. True, clear and accurate Information must be provided in both prospectus and public document if any issued to all the actual and future clients (future shareholders) both in subsequent reports and during the sales process. The example here is that of the validity *Murabahah*. The requirement here is that the seller has to disclose the original cost, any discount received in the original cost plus the profit. The same principle of transparency applies to the commissions and agency fees. That the cost must be truly disclosed and the commissions and agency fees must also be clearly mentioned for financing or *takaful* products.¹⁹²

3.6.2 Transparency as one of the basic principles of western corporate governance

Transparency defined

The term "transparency" is a compound word created from two single words "trans" which means moment and "parent" which means visible. Oxford English

¹⁹² Ibid p.3

Dictionary elaborates the term used in the early English as transparent in the following words:

“Having the property of transmitting light, so as to render bodies lying beyond completely visible”.¹⁹³

The above, mentioned definition of the term “transparent” covers the same property of seeing clearly in corporation, management, media, politics, sports and reading. But we have concern with transparency in corporations and transparency in management as both are the topics of our study. Some writers might argue that it is a western terminology but it is crystal clear that every individual and organization across the globe is having a great concern with it, regardless of race, creed, place of origin and religion.¹⁹⁴

The online business dictionary defines the term transparency in different ways such as:

“Minimum degree of disclosure to which agreements, dealings, practices, and transactions are open to all for verification.”

The term has been defined again as:

“Essential condition for a free and open exchange whereby the rules and reasons behind regulatory measures are fair and clear to all participants.”¹⁹⁵

The above definitions denote that western writers also consider transparency as one among the basic principles of corporate governance which provides for internal and external discipline to increase corporate performance, minimize business risk, and preserve the interests of investors and shareholders. The Organization for Economic Co-

¹⁹³ Simpson. John “Oxford English dictionary” Edition2, revised Publisher Oxford University Press, 1999

¹⁹⁴ W. Oliver Richard “*What is transparency?*” 1st Edition, Publisher (McGraw-Hill Professional, New York) 2004 p.3

¹⁹⁵ See <http://www.businessdictionary.com/definition/transparency.html> . Last visited on 01/06/2010 at 11:30 pm

Operation and Development (OECD) has mentioned a set of basic principles for the effective functioning of corporate governance mechanism in almost every country. Transparency is one among those basic principles which must be observed in an effective corporate governance system. Transparency and disclosure in an organization should be observed as:

- a. Disclosure of all important information accurately from time to time;
- b. Disclosure of the financial status of corporation or business, its performance, ownership and monitoring hands;
- c. Disclosure of accounting standards; and
- d. Audit of all the statements related to audit (Audit Statements).¹⁹⁶

3.6.3 Responsible Transparency a mean for Credibility

Transparency should be employed with a keen understanding of the effects of revealed information which it carries in its essence, it can be fair and responsible both to the organization and individual members concerned. Otherwise its effect will be vise-versa on both the organization and its members. Leaders of an Organization are required to know deeply the information absorbing capacity of people concerned. They have to anticipate how the revealed information might be used and interpreted.¹⁹⁷

Credibility and transparency denotes the relationship between two or more individuals. It is impossible for a person to be transparent unless some one transparent accompanies him or her. Similarly, the degree of credibility has a direct relationship with

¹⁹⁶ Center for International private Enterprise “*Corporate governance for Emerging Markets*”. Booklet Publisher (CIPE August) 2008 p.6 available online on <http://www.cipe.org> Last. Visited on 01/06/2010 at 12.00 pm

¹⁹⁷ Pagano, Barbara “*The transparency edge: how credibility can make or break you in business*” Edited by Elizabeth Pagano Publisher (McGraw-Hill Professional, New York) 2004 p.3

the perception of another person. There are some specific behaviors necessary to be adopted by each and every individual-specially by the leaders- in an organization. These behaviors, if adopted, will determine they way for being transparent. The following are those conducts namely:¹⁹⁸

- a. Being Extremely Honest
- b. Acquiring Intelligence ¹⁹⁹
- c. Being Composed²⁰⁰
- d. Promise keeping
- e. Mistakes Handling
- f. Being Caring
- g. Avoiding Harmful Comments and
- h. Handling bad news

Transparency carries in its essence the meaning of conveying the truth. David Heald –a western finance commentator – has come up with a theoretical mechanism for analyzing transparency. He distinguishes between:

- a. Transparency upwards: Here the superior or principal has the ability to have a check on the behavior of subordinate or agent

¹⁹⁸ Ibid p.4,5,6

¹⁹⁹ For example: to learn, grow mentally by using self awareness, asking for performance evaluation and perceptions of others about them. The Ironic input from other persons shall hopefully improve a plan for development and compatibility of intentions with reality. See for more details "*The transparency edge: how credibility can make or break you in business*" by Barbara Pagano and Edited by Elizabeth Pagano p.4

²⁰⁰ Composure is required for good leadership. Accepting challenges, facing the stressed situations, hurdles in organization and the ways in which leaders face these kinds of situations and tackle them are the parameters for their competence, and credibility. See for more details "*The transparency edge: how credibility can make or break you in business*" by Barbara Pagano , Edited by Elizabeth Pagano p.4

- b. Transparency downwards: In which the subordinate or the ruled one possesses the ability to observe the behavior of the superiors or rulers
- c. Transparency outwards: In this kind of transparency the subordinates inside an organization can have a check on the conduct of those who are outside the organization; and
- d. Transparency inwards: In which the conduct of those inside the organization can be observed by those outside it.

The above framework of David Heald is a useful one because it is a compound framework of some ways in which power and control may be regularized around the business organization.²⁰¹

Thus, in the light of the above discussion it may be said that the corporate culture and business behavior can only be improved by ensuring a transparent and impartial communication of information regarding the business activities. One might misuse such information by misinterpreting or by spreading harmful comments and it may only be handled using an honest exposure and due intelligence. A corporation's aim should not merely be profit maximizing but it should be responsive to the community as well. All the information regarding the operations of corporation, its contribution towards the welfare of public and its policies should be disclosed transparently. The conduct of every one among the inside and outside organs of the corporation should also be monitored and supervised transparently for the greater interest of business organization and all the stakeholders.

²⁰¹ Henriques Adrian “*Corporate Ftruth: the limits to transparency*” Publisher (Earthscan, Publishes UK) 2007, Pp.30,31

3.7 Business Organization between rights and responsibilities: An Islamic Perspective

In this part of the thesis we will discuss rights and liabilities of the board of directors, management, and auditors of the business organization from an Islamic perspective.

Islamic financial system is different from conventional systems in a sense that it is based on the rules of *Shariah*. The ultimate goal of this unique system is to ensure the maintenance of just and harmonious social behavior. In an Islamic corporate governance mechanism, not merely the rights of the stakeholders of a corporation be recognized, but their constitutional rights should also be protected.²⁰²

Hence a business organization is composed of management, board of directors, Chief Executive Officer, internal and external auditors and all of them have to play an important role in running the organization in accordance with the aims and goals of the business entity, therefore it is essential to discuss their functions and duties assigned to them by Islam for the assurance of a fair and just business environment. The responsibilities of each among them are vital and will be discussed in a bit detail.

3.8 Board of Directors: It's Islamic essence

Islam, as a comprehensive religion and a way of life, always emphasized on the preservation of *Maqaasid –al-Shariah* (Objectives of *Shariah*). One among those objectives is the preservation of property or *Hifz-al-Mal*. It is the duty of the leaders of a

²⁰² Iqbal Zamir, Mirakhor Abbas "Satkeholders Model of Governance in Islamic Economic System" research article available online on <http://www.irti.org> Last visited on 21/07/2010 AT 1:30 PM

business organization to adopt measures which are necessary for the safeguard of shareholders and other investor's capital from being lost or destroyed by the unethical, corrupt behavior of the business runners. For this purpose, directors of an organization are responsible to make policies and adopt such a decision making process which favors such goals of the business.

Islamic business organizations should always meet the expectations of public and those who really have a concern with how Islamic is the business of organization. Such kind of hope leads to a two-tier or bi-sided governance mechanism such as:²⁰³

- a. *Shariah* Supervisory Board or SSB and
- b. Board of Directors or BOD

3.9 *Shariah* Supervisory Board: the affix monitory and governance Institution

Before discussing the details of *Shariah* Supervisory Boar, it is necessary to mention here that Islamic corporate governance mechanism is a *Tawhid* (Unity of God) based mechanism which stands on the pillars of (*Khilafah*), trust (*amanah*) and justice (*al-adl-wal-Ihsan*). There must be the element of *Shura* (consultation) and it is an obligation that all the stakeholders must possibly participate, either directly or through their representatives, in the affairs of corporation.²⁰⁴

²⁰³ See Bakhtiar Ahmed, Nazli Mohammad on "Islamic Worldview and Effective Corporate Governance" p.29 Research article online source www.iiu.edu.my/.../IslamicWorldview_EffectiveCorporateGovernance_BahkandNazli.doc Last Visited on 29/07/2010 at 03:18 PM

²⁰⁴ Zulkifli Hasan "Corporate Governance: Western and Islamic Perspectives" .Research paper published in International Review of Business Research Papers Vol. 5 No. 1 January 2009 p.284

The institution of *Shariah* Supervisory Board (SSB) plays a vital role in determining the answer of the question, that whether the activities of corporation are in compliance with *Shariah* or not?²⁰⁵ It is expected to have a great influence in the board of directors (BOD), which is considered an affix authority in a normal business entity or corporation. This influence is normally reflecting the authority of SSB for giving advice to the BOD regarding the compliance of the corporation activities to *Shariah*. There should be an Internal *Shariah* audit (ISA) to assist the *Shariah* Supervisory Bard in examining the degree of compliance of the corporation's operations to the Islamic principles.²⁰⁶

Hence the *Shariah* Supervisory Board has to play the role of a highest monitoring institution; therefore it is derived that its authority should be recognized in the Article of Association (AOA)-the internal constitution of a corporation-for the better implementation of its suggestions and recommendations regarding the compatibility of the organization's operations with the principles of Islam.

3.10 The Board of Directors (BOD)

The term “Board of Directors” has been defined in the very first chapter of the thesis, its general functions and duties have been discussed there. Here I shall come up with its suggested composition by various Muslim finance scholars and its Islamic functions. The composition of board of directors in terms of its structure is suggested is that; the board of directors should be consisted of both the executive and non-executive directors. It should have the majority of non-executive directors. Some Codes of Best

²⁰⁵ Ibid

²⁰⁶ Op .cit p.30

Corporate Governance Practices, like Malaysian Code, the Combined Code The Islamic Banks Code of Best Practices for Corporate Governance emphasize the significance of having independent²⁰⁷ non-executive directors.²⁰⁸

In Islamic Financial Industry, while analyzing the legal framework, most of the jurisdictions are clear that the board of directors is responsible for the governance of Islamic Financial Industry.²⁰⁹ The logic behind the majority of directors to be non-executive is that the non-executive or non-working directors will monitor the activities of executive or working directors more effectively. This kind of supervision will make sure that all the deeds and activities of the executive directors are for achieving the interests of corporation and not of their own. There should be no “sleeping directors”, who really do not have concern with what is going on with the business of the corporation.²¹⁰

Both the executive and non-executive directors should refer to the *Shariah* Supervisory Board in decision making process. It will make sure that the Islamic principles are not violated. The non-executive directors have to head the nature of audit, while the executive directors are responsible for monitoring the day-to-day activities of the corporation. Thus it is clear that the board of directors have to issue the directives and monitor the business of organization as well, therefore they have to implement the

²⁰⁸ See Bakhtiar Ahmed, Nazli Mohammad on “*Islamic Worldview and Effective Corporate Governance*” p.30 Research article online source www.iiu.edu.my/.../IslamicWorldview_EffectiveCorporateGovernance_BahkandNazli.doc Last Visited on 28/07/2010 at 11:37 AM

²⁰⁹ Islamic financial services Board “*Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial services(Excluding Islamic Insurance Institutions and Islamic Mutual Funds)*”Exposure Draft No.3 21 December 2005 p.4

²¹⁰ Ibid p.31

suggestions, objections and recommendations of *Shariah* Supervisory Board (SSB) for the effective and efficient compliance of the overall operations of the organization.²¹¹

Dr Abdussalam Mahmud Abu Tapanjah is of the opinion that the duties of the board of directors in an Islamic corporation will be the following:²¹²

- a. It shall not merely be held accountable to the company, board , or stakeholders but to Allah (S.W.T) as well—the sole authority and owner of all the assets
- b. Consultation and seeking the favor of related stakeholders on each decision making and
- c. Co-operation and negotiation with all the stakeholders of the corporation.

Concluding the above discussion, it is stated that Islamic corporate governance mechanism is a *Shariah* rule based mechanism. *Shura* (Consultation in decision making), Accountability (*Ihtisab*), Vicegerency(*Khilafah*), trustworthiness (*Amanah*) and transparency are the key values to which every organ of the corporation must adhere. These values are also applicable to the board of directors in a sense that directors should feel that they have been assigned the duties and authority as a trust from Allah, which should be exercised by them applying the principle of *Shura* (Consultation) while making decisions. They should have the sense of accountability to Allah, shareholders and the society at large, for a transparent and reliable corporate culture.

²¹¹ Ibid

²¹² Abdussalam Mahmud Abu Tapanjeh “*Corporate governance from the Islamic perspective: A comparative analysis with OECD principles*” p.10, 11, 12 Research Paper. Available online on <http://linkinghub.elsevier.com/retrieve/pii/S104523540800021X> Last Visited on 26/07/2010 at 12:30 PM

3.11 Management of the Corporation: An Islamic perspective

The term “management” has been defined and elaborated in the very first chapter of this research, therefore it is not necessary to repeat it, but here the term refers to the top-level managers of the corporation. They have to implement the decisions made by the BOD and to execute their directives. They must be able to assign responsibilities to subordinates. Managers are termed more expert people in terms of company’s business activities.²¹³

Ahmed Bakhtiar and Muhammad Nazli- Islamic Finance scholars- state that the role of management should be like a bridge between the directors and the lower-level employees of a company. Any sort of confusion, or recommendation should be communicated accordingly through management in order to ensure a smooth working environment. In some situations, conflict may arise between the board of directors and management, like unethical board members may direct the managers to exercise malpractice. In this sort of situation, managers feel obliged to obey the directions for securing their positions as they realize that they are remunerated and salaried by the company.²¹⁴ The position of managers will become clearer after applying the moral and religious Islamic principles to their responsibilities as being Muslims we can’t deviate from those norms which are connected to our every day life.

²¹³ Op.cit p.32

²¹⁴ Ibid

3.12 Management of corporation and Islamic Scholarship

It is well known that the early Muslim scholars didn't remain aliens to the company's behavior, its management and social responsibility. Islamic governance system works on the principle of *Al-Maslahah*²¹⁵. The work of early Muslim Scholars is also based on the principles of no-injury or *Maslahah*. It is well known Islamic phenomenon, that the worldly good are to be used for the benefit of society at large and no body has the authority or right to cause any sort of loss to the other society members. Islam trains the man for the development of his moral behavior and the ways how these morals to be used for a swift economic coordination. All this needs a comprehensive work for understanding the behavior of all the stakeholders of a firm under *Shariah*.²¹⁶

The principle of *Maslahah* denotes that public interest will be preferred on individual interest. This principle provides for improvement and adaptation of the change. The golden principles of *Maslahah* can also provide for refining the role of business in terms of corporate governance. The managers and stakeholders can take guidance from *Maslahah* in making a moral decision, especially in solving the issues arising during the business activities of the corporation.²¹⁷

²¹⁵ Imam Ghazali R.A has defined the term "Maslaha" in his famous book *al-Mustasfa* as: "an expression for seeking benefit (*mansaah*) or removing something harmful (*mudarra*)". He elaborates the term further, that it essentially preserves the objectives of *Shariah* (*Maqaasid al-Shariah*), which includes: preservation of religion, life, intellect, progeny and property. He sums up by saying: "What assures the preservation of these five principles is *maslahah* and whatever fails to preserve them is *mafsadah* and its removal is *maslahah*" See *Al-Ghazali on Al-Mustasfa (A return to Purit)* Translated by Abdullah bin Hamid Ali Publisher (Lamp Post Productions)2008 Pp. 140,141

²¹⁶ Toseef Azid, Mehmet Asutay, Umar Burki "Theory of the Firm, Management, and Stakeholders: An Islamic Perspective" Research article published in Islamic Economic Studies Vol. 15, No1, July 2007 p.6.

²¹⁷ Dr Dusuki Asyraf Wajidi "Corporate governance and Stakeholder Management of Islamic Financial Institutions: An Islamic Perspective" Research Paper presented in National Seminar in Islamic Banking and Finance 2006, KUIM, Nilai, 20th-30th August 2006 p.9

The Holy *Qur'an* which is a complete Code of life clearly mentioned that the complete loyalty of Muslims should be to Allah (S.W.T) and His Messenger (S.A.W). Muslims may also follow the instructions of others as long as those instructions are not repugnant with the requirements of *Shariah*. The Holy *Qur'an* states;

“Obey God, and obey the Apostle, and those charged with authority among you. If ye differ in anything among yourselves, refer it to God and His Apostle, if ye believe in God and the Last Day: That’s the best and most suitable for final determination”²¹⁸

The verse clearly states that the loyalty should be absolutely to Allah (S.W.T) and His Messenger (S.A.W). In other certain situations it may be to other persons, but in accordance with the directions of *Shariah*. It means that men should always be independent otherwise blindly following the other person’s instructions will cause their involvement in fraudulent dealings.²¹⁹

In contemporary practices of company, the management has either to obey the unethical directives or to resign from their positions and there is no redress for management in facing such kind of immoral situation. Therefore, it is suggested that there should be a bridge between the non-executive directors and management. It shall lead the management to feel free and comfortable in communicating any sort of unethical directives from the executive directors of the company. It is because that the non-executive directors²²⁰ have the authority to supervise and monitor the activities of executive directors, therefore they can effectively solve these kinds of issues. On the

²¹⁸ Qur'an 4:59

²¹⁹ Op. Cit

²²⁰ They are also termed as Non-working directors. They don't take part in day-to-day management of the firm. His or Her usual responsibility is to involve in planning and policy making. Hence he or she gets stand in the society, therefore is sometimes included for lending prestige to the company. They also have to monitor and challenge the activities of executive directors and the management with a firm determination to protect the interests of the company and its stakeholders.

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other hand if the management themselves got involved in any kind of malpractice or fraudulent activity, then the internal auditors(IA) and *Shariah* internal auditors(SIA) – which should be there in every firm-should act like effective “monitors”. Both of these units-(IA) and (SIA)-will have to make ensure that the management is following the prescribed procedure and has not involved in contravening the internal control mechanism of the firm.²²¹

Concluding the discussion on Islamic perspective of corporate management the standards of qualitative management are narrated as following.²²²

1. The management must seek the customer's satisfaction as well as compatibility of the business processes with the principles of *Shariah*.
2. Self-management should be ensured in the business organizations: It signifies that the management should adopt the ways in which it shall conduct it's-self by adopting the right motives and doing the right deeds, which shall also affect the environment around it .It will become a benchmark for the good governance of other's as well by ensuring good moral behavior, justice and righteousness in the corporate culture.
3. Participative management-sharing the responsibility- should be ensured in the corporations. Allah (S.W.T) clearly mentioned in the Holy *Qur'an*:
“Let there arise out of you a band of people inviting to all that is good, enjoying what is right, and forbidding what is evil”.²²³

²²¹ See Bakhtiar Ahmed, Nazli Mohammad on “*Islamic Worldview and Effective Corporate Governance*” p.33 Research article online source www.iiu.edu.my/.../IslamicWorldview_EffectiveCorporateGovernance_BahkandNazli.doc Last Visited on 24/07/2010 at 5:30 PM

²²² Azauddin Syed, Bahaldin Syed “*Alternative Quality Management Standards Islamic Perspective*” Publisher (Ustan Publications Malaysia Kuala Lumpur) 56100,Pp.15-18

Hazrat Ibn-e-Abbas R.T.A narrates from the Holy Prophet (S.A.W) that the Holy Prophet (S.A.W) said that:

“The Hand of Allah (S.W.T) is with the entire community”²²⁴

Hence every individual in an organization has to play a certain role, but no one should blame other for any thing that goes wrong during the course of shared responsibility. However, everybody is accountable for his activities and deeds.

The conclusive remarks on the topic under discussion are that: Hence, the management of a corporation is playing the role of a bridge, e.g it communicates the suggestion, confusions and issues of the lower-level employees to the top-level personals and vise-versa. They also manage the capital provided by the shareholders and run the business. Therefore it should have a sense of accountability to Allah (S.W.T) and the society at large. They should be provided a free working environment to play their role independently without exerting any kind of pressure. The directives of the board of directors-which are just and issued with good intention- should be considered and implemented accordingly, but those which are issued for malpractice by the managers are to be communicated to the non-executive directors-as they are monitoring the activities of the executive directors- for any proper action in this regard. In short, the highest degree of moral behavior is required to be adopted by the management, and all the other organs for good corporate governance practices.

²²³ Qur'an 3:104

²²⁴ *Termidhi, Hadeeth* number 1848, also narrated by Ibn-Umer R.T.A with added words that the Holy Prophet (S.A.W) P.B.U.H said that “Allah (S.W.T) does not collect my *Ummah*, or He P.B.U.H said , the *Ummah* of Muhammad (S.A.W) upon an error or what is wrong”

3.13 Implementing the vision of Islamic Corporate Governance Model

As we have discussed the values and principles for *Shariah* governance in this chapter, the Islamic corporate governance model of Dr Abdussalam Muhammad Abu-Tafanjeh will be discussed.²²⁵ He sums up the principles of Islamic corporate mechanism while making a comparison between the Organization for Economic Co-operation and Development Principles of Corporate Governance and Islamic Principles and presents the following model of *Shariah* governance:²²⁶

1. While ensuring the foundation for an effective model of Islamic corporate governance the following things must be considered:
 - a. The business should be promoted within the ethical and moral boundaries of *Shariah*
 - b. Belief in sharing the profit and loss must be there²²⁷
 - c. The principle of Prohibition of *Riba* or Interest must be ensured
 - d. Serious efforts must be made to promote justice and public welfare as a religious and social duty
2. The Shareholders Rights and significant ownership activities are to be exercised keeping in minds that:
 - a. Property is Allah's trust
 - b. Allah (S.W.T) is ultimately the sole owner and He has the sole authority

²²⁵ Dr Abdussalam Muhammad Abu-Tafanjeh is the Head Department of Accounting, Business Administration College, Faculty of Business Administration, Mutah University Krak, Jordan

²²⁶ "Corporate Governance from the Islamic perspective: A comparative analysis with OECD principles" Research Paper by Abdussalam Mahmud Abu Tapanjeh p.10, 11, 12. Available online on <http://linkinghub.elsevier.com/retrieve/pii/S104523540800021X> Last Visited on 26/07/2010 at 12:30 PM

²²⁷ Because it is one among the basic general principles of Islamic Law of business contracts that entitlement to profit is based on liability to bear the loss, and this meaning is also conveyed in the *Hadeeth* of the Holy Prophet (S.A.W): "Usufruct devolves with liability" as quoted in "Islamic Law of business contracts and Business transactions" Page. 13

- c. Society members at large are also stakeholders
- d. All the shareholders or owners are accountable not merely to Allah (S.W.T) but also to stakeholders

3. The shareholders of Corporation must be equally treated by the implementation of:

- a. Distribution of wealth among all the stakeholders and other needy members of the society in the form of *Zakat* and *Sadaqat*
- b. Avoiding unjust and unfairness of value
- c. Realization and observance the sense of equality

4. The stakeholders will play a role in corporate governance by considering the:

- a. Conception of *Shariah* accountability as a mean to success (*Falah*) and welfare of the society at large
- b. Phenomenon of *Halal* (Permissible in the eye of *Shariah*) and *Haram* (Prohibited) in business transactions
- c. Welfare of society as a whole and of person individually from both the material and spiritual aspects

5. The Principle of Disclosure and transparency by assuring:

- a. The sense of accountability in compliance with *Shariah*
- b. The Socio-economic aims and goals relevant to the control of corporation and it's accountability to all its stakeholders
- c. ²²⁸ The principle of justice equitable treatment to all the shareholders, truthfulness and transparent disclosure of information
- d. The broad sense of accountability in written and oral form of disclosure

6. The duties of the board of directors will be the following:

- a. It shall not merely be held accountable to the company, board , or stakeholders but to Allah (S.W.T) as well—the sole authority and owner of all the assets
- b. Consultation and seeking the favor of related stakeholders on each decision making and
- c. Co-operation and negotiation with all the stakeholders of the corporation.²²⁹

All the above discussed ingredients of Islamic corporate governance model are notably evident that the practices of corporate governance in the contemporary business entities of various countries -especially Muslim world- are in need to be substituted by Islamic corporate governance practices based on Islamic principles. The study shows that Islamic world had its own values of good governance practices. Muslims always believed that they are accountable in both the words to Allah (S.W.T) which governed social life as well as their corporate culture. Briefly summarizing the discussion, we may say that Islamic corporate governance model has strongly connected with *Shura*, Accountability, *Shariah* supervisory process and *Shariah* audit.

²²⁹ Op.Cit p.12

CHAPTER 4

THE PRACTICAL IMPLICATION OF THE ISLAMIC IDEA OF CORPORATE GOVERNANCE IN ISLAMIC BANKS IN PAKISTAN

In this part of the thesis the practical implementation of *Shariah* corporate governance in Pakistan will be elaborated. The Securities and Exchange Commission of Pakistan has incorporated some principles in the shape of Corporate Governance Code for good governance of companies listed on Pakistan's stock exchanges. Using its powers under section 34(4) of the securities and Exchange Ordinance, 1969, the SECP issued directives to the Karachi, Lahore and Islamabad Stock Exchanges for incorporating the provisions of the Code of Corporate Governance in their listing regulations. The above mentioned Code of Corporate Governance lacks the compliance with the Islamic Idea of corporate governance. Therefore Islamic financial Institutions were in the need of policies, so that these institutions may be governed under those provisions.

The State Bank of Pakistan, established under the State Bank of Pakistan Act, 1956 (as amended up to 2003) governs all the banks in Pakistan and issues policies and guidelines from time to time for the guidance of these financial institution. The said governing bank is a corporate body and regulates the monitory and credit system of Pakistan and works for its growth in the best national interest for securing the monetary stability of the country.²³⁰ This corporate governing body also regulates the business and dealings of the Islamic financial institutions/Islamic banks and the *Shariah* Board which

²³⁰ See The State Bank of Pakistan Act 1956 (as amended up to 2003).p.1

comprises of *Shariah* Scholars and academicians, issues guidelines, approves and incorporates some of the recommendations given by different stockholders. These guidelines and suggestions are reckoned Essentials of Islamic modes of Financing and their aim is to ensure that the business activities and dealings of Islamic banks are in compliance with minimum *Shariah* Standards. These requirements and guidelines are issued by the Islamic Banking Department of State Bank and are required to be followed by banking institutions deal with Islamic banking in Pakistan.²³¹ The details about the supervisory role will be elaborated more in the coming part of this chapter, but here I have to explore the term “corporate governance” from the banking and Islamic banking perspective.

4.1 Corporate Governance defined from Banking Perspective

The word “corporate governance” has been defined generally in the very first chapter of the research. Hence in this part, the application of this concept is discussed in the Islamic financial institutions; therefore the term is required to be defined from the banking perspective as well. The term has been defined in the Basel Committee report on banking supervision as follows:²³²

“From a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their board of directors and senior management, affecting how the banks.”²³³

²³¹ <http://www.sbp.org.pk/press/Essentials/Essentials-Mod-Agreement.htm> Last accessed on 21/08/2010 at 9:45 PM

²³² Basel Committee on Banking Supervision “ *Enhancing Corporate Governance in Banking organizations* ” a Banking Supervision Report Publisher (The Basel Committee) September 1999.p,6

²³³ Ibid

- a. Set corporate objectives (including generating economic returns to owners)
- b. Run the day-to-day operations of the business
- c. Consider the interests of recognized stakeholders- According to Basel Committee's Report the term "Stakeholder means employees, customers, suppliers and the community. Due to the unique role of bank in national and local economies and financial systems, supervisors and governments are also stakeholders" ²³⁴
- d. Align corporate activities and behaviors with the expectation that bank will operate in a safe and sound manner, and in compliance with applicable laws and regulations, and
- e. Protect interests of the depositors"²³⁵

The above definition may be termed as preferred one in banking perspective, as it discusses that the banks are run, organized and governed by the board of directors and top-level management. The definition also prescribes the functions of the board and senior management for running these banking organizations. This definition can not be named a comprehensive definition from Islamic banking perspective. The reason is that there is no reference to a *Shariah* supervisory board and their functions for supervision and monitoring the business activities of the banking organizations. Therefore there is need for defining the term" corporate governance" from Islamic banking perspective. An

²³⁴ Ibid

²³⁵ Ibid

attempt has been made for such a definition of the term, which may point out the ingredients of the term from Islamic banking perspective.²³⁶

The role of the *Shariah* supervisory board is more significant in an Islamic Bank. It means that the *Shariah supervisory* board (SSB) is a necessary element of governance in Islamic banking. The logic behind this is that the said *Shariah supervisory* board is established according to the spirit of *Shariah*. The said board normally comprises of *Shariah* Scholars and academicians, and is an independent board of *Shariah* Scholars, whose duty is to direct, review and supervise the activities of Islamic banks for the purpose of their compliance with *Shariah* and to issue *Sariah* rulings required for regulating the activities of Islamic Financial Institutions.²³⁷

The function and role of *Shariah* Supervisory Board has a great influence on the activities of Islamic banks and therefore the State bank of Pakistan has mentioned its existence in guidelines for Islamic banks. The criteria for the membership of such a board, the educational qualification, experience and exposure required from him, his track record, the composition of *Shariah* Supervisory Board, its role and key functions will be discussed in detail.

²³⁶ Keeping in view the aims corporate governance in *Shariah*, the term may be defined more comprehensively from the Islamic Banking perspective as:

“From the Islamic banking perspective, corporate governance involves the manner in which the affairs of the banking management are regulated, the business and affairs of individual Islamic financial institutions are governed by the *Shariah* Supervisory Board established according to the spirit of *Shariah* affecting how banks:

- a. Set corporate objectives in compliance with *Shariah*
- b. Run the day-to-day business activities according to the Islamic business principles
- c. Consider the interests of stakeholders recognized by *Shariah*
- d. Align corporate activities and behaviors with the expectations that Islamic banks will operate in safe and sound manner, and in compliance with applicable *Shariah* compliant laws and regulations and
- e. Protect interests of the depositors

²³⁷ <http://www.hawkamah.org> See *Hawkamah* newsletter Issue 10 volume 1 p.2 visited on 22/08/2010 at 12:30 PM

4.2 The Importance of Corporate Governance for Islamic Finance

Islamic Financial Industry defined:

After a long period of declination, the last three decades observed inclination in the growth of Muslim world's economy, especially after 1973-74. The reemergence was pumped by the introduction of Islamic financial products according to the demand by Muslim masses for *Shariah* compliant financial services. Here the question arises that what do we mean by the Islamic Financial Industry?

The Islamic Financial Services Board's "*Islamic Financial Services Industry Development*" Ten Year Framework and Strategies has defined Islamic Financial Industry as follows:

"IFI consists of : (i) Islamic Banks, (ii) Islamic non-banking Financial Institutions including Islamic Leasing and Factoring Companies, Finance Companies, *Ijarah* and *Mudarabah* Companies, Islamic Housing cooperatives, Islamic Microfinance Institutions, Credit Sale Subsidiaries of Trading Companies and other similar Institutions, and private equity/venture Capital, *Haj* funds, *awqaf*, *zakah* and *sadaqah* managing Institutions, (iii) *Takaful* or *re-takaful* operators (iv) Islamic Capital Markets and their players, (v) Islamic Financial Architecture and Infrastructure and Currently IFSI consists of : (i) Islamic Banks, (ii) Islamic non-banking Financial Institutions including Islamic Leasing and Factoring Companies, Finance Companies, *Ijarah* and *Mudarabah* Companies, Islamic Housing cooperatives, Islamic Microfinance Institutions, Credit Sale Subsidiaries of Trading Companies and other similar Institutions, and private equity/venture Capital, *Haj* funds, *awqaf*, *zakah* and *sadaqah* managing Institutions, (iii) *Takaful* or *re-takaful*

operators (iv) Islamic Capital Markets and their players, and (v) Islamic financial architecture and infrastructure”²³⁸

This industry started its operations with a new horizon of growth for a number of reasons.

These reasons were as follows:

- a. The uncertain performance of western financial services
- b. The highest degree of risk for Gulf Cooperation Council investment in traditional financial markets
- c. The explicit demand from Muslim residents in the western world and
- d. The development of managerial exposure required providing Islamic financial services.

The Islamic Financial Services Industry now comprises of banks providing services and products in more than thirty eight countries, both Muslim and non-Muslim.²³⁹

Islamic Financial Institutions (IFIs) started their operations with their conceptual base and operational activities carried certain features that posed certain new challenges to their regulators and they felt a need for the solution of such kind of issues. As a result of this dilemma, various countries established laws and regulations for Islamic financial institutions and international bodies, such as Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAIFI), the International Islamic Financial Market (IIFM) and the Liquidity Management Centre

²³⁸ Islamic Financial Services Board “*Islamic Financial Services Industry Development*” Ten Year Framework and Strategies, Policy Dialogue Paper No.1 Publisher (IFSB .Kuala Lumpur Malaysia) Pp,22-23

²³⁹ Wafik Garis, Matteo Pellegrini “*Corporate Governance in Institutions Offering Islamic Financial Services*” a World Bank Policy Research Working Paper 4025, Published in November 2006, p.3

(LMC), have been created for adapting and harmonizing the conventional standards practices.²⁴⁰

Good governance practices in Islamic Financial Institutions ensure the growth of a major source of wealth generation and investment-Islamic Finance- on global level. The worth of total Islamic Finance's transactions has crossed the limit of trillion dollars. The reason is that Islamic Financial Institutions provides a choice to both the investors and savers, who are interested to deal merely with Islamic financial system according to the principles of their religion and ideology.²⁴¹

The status of an Islamic Financial Institution is principally that of a company, and it has to follow, adopt and obey the general principles of corporate governance that are applicable internationally such as the corporate governance principles issued by the Organization for Economic Cooperation and Development in 1999 revised in 2004²⁴² and other guidelines that have been issued both on global level and regional level. However, Islamic Finance is a unique industry, based on the unique principles of the Holy *Qur'an* and *Sunnah*. Its distinct view on qualified financial transactions offers a concrete, rich and superior mechanism to the field of corporate governance. The core principles of corporate governance for Islamic Financial Institutions are the concept of justice, moral obligation, accountability and equality which are also the basic tents of Islamic Ideology. Similarly the principle of sharing loss also makes them unique and

²⁴⁰ Ibid. p,4

²⁴¹ Dr Shmshad Akhtar "Sahriah Compliant Corporate Governance" Address by Ex Governor of the State Bank of Pakistan, at the Annual Corporate Governance Conference, Dubai, 27 November 2006. p,1

²⁴² OECD Principles of Corporate Governance as revised in 2004; include "(i) Ensuring the Basis for an Effective Corporate Governance Framework,(ii) The Rights of Shareholders and Key Ownership Functions, (iii)The Equitable Treatment of Shareholders, (iv) The Role of Stakeholders in Corporate Governance, (v) Disclosure and Transparency, and (vi) The Responsibilities of the Board of Directors"

different from the conventional financial Institutions.²⁴³ This fact has also been discussed by the Muslim Jurists that the commercial activities by the Muslims should strictly abide by the two main principles namely:

1. Entitlement to Profit is based upon the liability for bearing the loss (*Al-Kharaj bil-daman*) and
2. Prohibition of *Riba* (Usury)

The other Islamic business principles²⁴⁴ also strictly apply to the business operations conducted by Muslims whether in the shape of corporate activities or individual commercial transactions. All of them are the governing business principles for regulating the trade dealing of Muslims according to the spirit of *Shariah*.

Corporate Governance for Islamic financial institutions is unique; the reason is that it stems out from two basic principles namely:²⁴⁵

1. Faith based approach that requires from the Islamic financial institutions to conduct their business according to the principles prescribed by *Shariah* and
2. Profit-motive, that gives a legal status to the trade and commercial transactions and maximization of shareholder's capital etc.

Some time these elements are perceived to be in contradiction with each other therefore corporate governance for Islamic financial institutions has to solve these carefully in an affective manner. This purpose can be achieved by providing a mechanism that offers a framework for the growth and strengthening of the system.²⁴⁶

²⁴³ Op.Cit

²⁴⁴ Mansoori Muhammad Tahir ““*Islamic Law of business contracts and Business transactions*” 3rd Edition 2005 Publisher (*Shariah* Academy International Islamic University Islamabad) Chapter 1

²⁴⁵ Op.cit, Dr Shmshad Akhtar “*Sahriah Compliant Corporate Governance*” Address by, Ex Governor of the State Bank of Pakistan, at the Annual Corporate Governance Conference, Dubai, 27 November 2006, p.1

²⁴⁶ Ibid

To conclude, the nature of Islamic finance is such that it always needs to be supervised and run under the moral and regulatory framework of *Shariah* based governance mechanism. Muslims always hold themselves accountable and they have to act transparently keeping in minds the legal obligation of fulfilling their religious and worldly duties. Therefore the runners of Islamic financial institutions have to abide by the principles of transparency, accountability and trustworthiness for the safeguard of the interests of customers and the institutions in accordance with the principles of *Shariah*.

4.3 The Historical Background of *Shariah* Governance in Islamic Banks

In this part of the thesis I shall have a glance on the historical background of Corporate Governance in Islamic Banks. The Study of relevant literature shows that first of all it was Dubai Islamic Bank and Kuwait Finance House which appointed Scholars as their *Shariah* advisors without scrutiny of their specialization in Islamic Commercial Law or any other relevant basic science required for the same position. The same was also the practice of various other Islamic Banks. But later on the need for specialists in Islamic Jurisprudence and Islamic Finance was felt since the issuance of ruling and *fatwa* regarding a certain financial matter needs deep knowledge of Islamic Law and existing legitimate practices. Hence arose the need for well versed specialist individuals in the legal, economic disciplines who have also the knowledge of Islamic Law to be appointed in the governing bodies for achieving the goals of good governance in Islamic Banks.²⁴⁷ The Sudanese experience of establishing a Central *Shariah* Governance body and *Shariah* sub-committees was also a milestone in the improvement of *Shariah* Governance

²⁴⁷ Muhammad Abdul Ghaffar Sharif “*al Raqabah al Sahriyyah al al Masarif wa al Sharikat al Islamiyyah*” Research Paper Arabic Version April 28 2008, p.2

in Islamic Finance. Then the Accounting and Auditing Organization for Islamic Financial Institutions and provided a control and governance mechanism to the Islamic Banks stipulating the establishment of *Shariah* Supervisory Board and *Shariah* Advisors in the Islamic Banks.²⁴⁸

One among the positive developments in *Shariah* governance is the sense of need arose in the Islamic financial Institutions for a central control representing a higher degree and specialized forum of reference for the standardization of banking operations both on a general level and separately in each country. This sense of such a need transformed to a serious struggle which produced patterns of central control, for instance the Supreme *Shariah* Auditing Council of the International Union of Islamic Banks named as General Council for Islamic Banks and Financial Institutions. The aim of this Council was to gather the experience of Islamic Banks which spread quickly across the Muslim world for their reliable operations. The other aim of this Council was to unify the jurisprudential options that meet the legitimate interests of the Muslim *Ummah*.²⁴⁹ This general council also aimed to provide investment services, banking services, human resource and training, dealings in agreements, *takaful* insurance and offer various new products for Islamic banks.²⁵⁰

The concluding remarks regarding the said general council are: that as said council means to ensure a central control, fair auditing practices and gather the business and commercial experiences of Islamic banks established across the world, therefore the said council plays a vital role in regulating the operations of member Islamic Banks. At

²⁴⁸ Ibid, p.2,3

²⁴⁹ Ibid

²⁵⁰ See <http://www.cibafi.org/NewsCenter/English/ProductsAndServicesNews.aspx>, Last accessed on 09/11/2010 at 6:52 PM

least this forum should be used for ensuring best governance practices compliant with *Shariah* and the regulators and other authoritative personals should be asked for the observance of accountability, transparency, trustworthiness and other paramount principles required for good governance practices. This thing will attract the trust and confidence of the customers and all those having a concern with Islamic banks. Besides this the said Islamic Banks should be asked to protect the rights and interests of minority and foreign shareholders for achieving the goals of role model entities for conventional banks.

4.4 State Bank and Corporate Governance in Pakistani Islamic Banks

As discussed earlier, the *Shariah* Board of the State Bank of Pakistan issues guidelines for regulating the business of Islamic banks in Pakistan, therefore it is essential to have a glance over the guidelines issued for regulating the business of Islamic banks in the country in special, and over those principles of corporate governance, minimum standards required for the governance of Islamic banks in general. These general principles are applicable to every Islamic bank whether it conducts Islamic banking in Pakistan or elsewhere in the world. The principles issued by Organization for Economic Cooperation and development, Islamic Financial Services Board, Accounting and Auditing Organization for Islamic Financial Institutions are mere guidelines and the Islamic Banking department of State Bank of Pakistan adopts those guidelines and principles in issuing policies for the operations of Islamic Banks in Pakistan.

4.5 The Guidelines and Regulations issued by State Bank

In this part of the thesis those guidelines will be discussed which are related to *Shariah* compliance of the business activities of Islamic banks in Pakistan as this chapter is about the Islamic idea of governance in Pakistani Islamic banks.

The strategies of the State Bank of Pakistan for the governance of Islamic and conventional banking institutions include:

- a. Prudential regulations issued for commercial banks
- b. Risk management guidelines for Islamic banks

The other strategies of SBP for Islamic banks are *Shariah* compliance. This strategic plan comprises of four disciplines namely:²⁵¹

- a. *Shariah* Board at central level (at SBP)
- b. *Shariah* advisors in all banks offering Islamic banking services
- c. Guidelines for all *Shariah* advisors in all banks deal with Islamic commercial activities and
- d. *Shariah* Compliance Inspection of all such financial institutions

All the above mentioned plans and strategies will be discussed in a bit detail, to elaborate the Supervisory role of the State Bank of Pakistan for Islamic banks wide the country.

4.5.1 State Bank's Prudential Regulations issued for Commercial Banks

To reduce the risk and maintain soundness of system in commercial banks, the State bank of Pakistan issues prudential regulations. These regulations are updated and

²⁵¹ See Strategic Plan for Islamic Banking Industry of Pakistan issued by Islamic Banking Department, State Bank of Pakistan. p, 15

amended from time to time. The last amendments were made in January, 2011 which are incorporated in the updated booklet for ease of the customers.

The Prudential Regulations consists of four parts namely:

- i. Risk Management
- ii. Corporate Governance
- iii. Customer Due Diligence and Anti Money Laundering and
- iv. Operations

These regulations are of binding nature and if any of these regulations are violated, the concerned bank/ officers are held liable and in case the violation is proved in due course of law, the responsible officer(s) are punished in accordance with the provisions of Companies Ordinance, 1962.

4.5.2 State Bank's Risk Management Guidelines for Islamic Banks

The nature of risk in Islamic bank is different from that faced by conventional banks, therefore special kind of risk management guidelines are issued by the State Bank to handle different kinds of risks faced by Islamic banks. These guidelines provide fifteen principles for handling different kinds of risks including the following kinds of risks:

- i. Credit risk²⁵²
- ii. Equity investment risk²⁵³
- iii. Market risk²⁵⁴

²⁵² Credit risk is defined as “the potential that counterparty fails to meet its obligations in accordance with the agreed term” .Credit risk also includes the risk arising in the settlement and clearing transaction. See SBP's Risk management Guidelines for Islamic Banks. p,4

²⁵³ Equity investment risk is defined as “it is a business risk caused by depreciation of investments due to stock market fluctuations”.

- iv. Liquidity risk²⁵⁵
- v. Rate of return risk and²⁵⁶
- vi. Operational risk²⁵⁷

4.5.3 *Shariah Board of the State Bank of Pakistan*

The State Bank of Pakistan is corporate governing body established under the State Bank of Pakistan Act 1956 (as amended up to 2003) for regulating the business of banks in Pakistan. This corporate governing body also regulates the business and dealings of the Islamic financial institutions/Islamic banks and the *Shariah* Board which comprises of *Shariah* Scholars and academicians, issues guidelines, approves and incorporates some of the recommendations given by different stockholders.²⁵⁸

²⁵⁴ Market risk is the name of risk of losses on-and off-balance-sheet positions arising from movement in market price. For example fluctuations in values in tradable, marketable or leasable assets (including sukuk) and off-balance-sheet individual portfolios (for example restricted investment accounts). The risk involved in future delivery of goods like the commodity price of a Salam asset, the market value of Sukuk, the market value of Muarabahah asst purchased to be delivered on a future date and the foreign exchange rates are also included in this kind of risk. See SBP's Risk management Guidelines for Islamic Banks. p,12

²⁵⁵ It is the potential loss to Islamic banking institutions arising from their inability either to meet their obligation or to fun increases in assets as they fall due without incurring unacceptable costs or losses.

²⁵⁶ The rate of return risk has been defined as "The risk associated with overall balance sheet exposures where mismatches arise between assets and balances from fund providers". It is different from interest rate risk in that Islamic banks can not pre-determine the result of their investment exactly. Therefore the result of their investment may vary at the end of investment, while the conventional banks pre-determine the interest rate at the beginning of investment.

²⁵⁷ Operational risk is arising from the failure of Islamic banking institutions in their internal controls involving processes, people and systems. This risk also causes for reputational risk. Eventually the reputation of the Islamic banks is injured due to the failure in governance, business strategy process and particularly *Shariah* non-compliance in their products and services.

²⁵⁸ Op.cit Dr Shmshad Akhtar "Sahriah Compliant Corporate Governance" Address by Ex Governor of the State Bank of Pakistan, at the Annual Corporate Governance Conference, Dubai, 27 November 2006. p,4

The country wise study of Islamic banking shows that the above mentioned *Shariah* board is also named as *Shariah* Committee. The following is the country wise *Shariah* Committee organ at the central level as: ²⁵⁹

- a. In Malaysia, the *Shariah* Advisory Council(SAC) plays the role of *Shariah* Committee at the central level
- b. In Bahrain the *Shariah* Supervisory Committee (SSC)
- c. In Indonesia the National *Shariah* Board (NSB)
- d. In Iran Council of Guardian and
- e. In Brunei it is the *Shariah* Financial Supervisory Board (SFSB) which issues guidelines and regulations for the activities of Islamic banks to be compatible with the norms of *Shariah*.

Hence the Islamic financial services of the banks offering such services increase throughout the country day by day, therefore there is severe need for the promulgation of Islamic Banking Law for regulating the business of all these financial institutions in accordance with the spirit of *Shariah*.

The suggested Islamic Banking Code/Law will provide a base for the elimination of *Riba* (usury) from the banking sector in Pakistan and for giving a stronger legal status to the Islamic financial institutions across the country. In this way the disputes between a customer/stakeholder and Islamic banking Institution and between two different Islamic banks may be adjudicated according to the provisions of that Islamic Banking Code which may be enacted by considering the provisions of AAOIFI's *Shariah* Standards.

²⁵⁹ Ibid,p.6

4.6 The role of *Shariah* Board at the Central Level

The *Shariah* board comprises not merely of *Shariah* scholars, but the chartered accountant, lawyer and central banker²⁶⁰ are also the members of the board. It is believed that Islamic law or *Shariah* is the core centre around which the activities of Islamic banking are revolving but additionally there are other critical aspects essential for the execution of *Shariah* standards and those disciplines must be observed within the *Shariah* board. This will not only lead the rulings issued by the said *Shariah* board to their 100% compliance with *Shariah* but will also make them compatible with the legal and financial mechanism present for Islamic financial institutions.²⁶¹

- The said board has also a duty of issuing ruling or *fatwa* on the point of any conflict which may arise out of the *Shariah* compliance inspection by the board. Its responsibility also extends to guide the State Bank of Pakistan on *Shariah* aspects of regulations framed and issued by the SBP. This obviously provides for product development and helps in approving any new product developed by the commercial banks.²⁶²

To analyze I shall state that the role of *Shariah* board has a direct relation with the general principles of business derived by the Muslim Scholars for the business activities. *Shariah* board has to ensure compliance with the legal and financial mechanism present for Islamic banks, but that mechanism should be in compatible with the *Shariah* general business principles, otherwise that mechanism has to be declared null and void by the

²⁶⁰ Normally the country director of Islamic banking,-who provides his services for the interests of both the Islamic commercial banks and the state bank of Pakistan on the forum of the *Shariah* Board-is appointed to be the member of *Shariah* Board at the central level.. See Dr Shamshad Akhtar's address on Corporate Governance at the conference Dubai. Hard copy's page no 4.

²⁶¹ Op.Cit. p,4

²⁶² Ibid

said board and recommendations for a new legal and financial mechanism for Islamic financial institutions should be presented and approved.

The above discussed *Shariah* board is also the requirement of Islamic financial services board and this requirement is clearly mentioned in the guidelines for the application of corporate governance for Islamic financial institutions in the following principle:

“The IIFS shall have in place an appropriate mechanism for obtaining *Shariah* rulings. Application of *fatawa* and monitoring of *Shariah* compliance in all aspects of their products, operations and activities”.²⁶³

It is crystal clear from the above principle that the institutions offering Islamic financial services should abide by the rules and principles mentioned by the Muslim jurists for business activities. The Muslim Jurists derived those detailed principles from the General provisions of the Holy *Qur'an* and *Sunnah* using the methodologies of classical Muslim Jurists for the derivation (*Istinbaat*). It means that they had a great concern with the commercial activities of Muslims since the preservation of property is one of the main objectives of *Shariah* (*Maqasid Al-Shariah*.) In the case there is situation faced by Islamic financial Institutions, about which the work of Muslim jurists is silent, then this gap should be filled by those scholars hired by the Islamic financial institutions in the shape of *Shariah* supervisory board. The same board will issue *fatawa* or *Shariah* rulings regarding that particular unprecedented situation and this board of *Shariah* Scholars shall also play a monitory role for the compliance of business activities, operations and products of the Islamic financial institutions with *Shariah*. The existence

²⁶³ See “*Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)*” Exposure Draft No 3 Published by Islamic Financial Services Board 21 December 2005 Part 3 Para 3.1.p.22

of lawyer, banker and an accountant in the said *Shariah* board has also been given preference for the compliance of business activities with the law of land, interests of the central bank and fair financial statements and reports.

- The Islamic financial Institutions would certainly have to play the role of implementers of the rulings and *fatawa* issued by the *Shariah* committee (a key player in the effective *Shariah* governance); the government will play the role of regulatory authority. The involvement of other relevant persons with the business operations of Islamic financial institutions is also important for affective *Shariah* governance, such as auditors, central bankers, accountants and lawyers.²⁶⁴
- In the case of conflict between various *Shariah* rulings, the opinion of *Shariah* board at central level (SBP's *Shariah* board) will have to prevail and its opinion is considered final in this regard, since the members of the said board are well acquainted with local and global banking and *Shariah* practices and therefore their opinion is considered to be in line with both, *Shariah* and International practices.²⁶⁵ It means that if there is difference of opinion between *Shariah advisory* committee of an Islamic commercial bank, Islamic banking subsidiary or Islamic banking branch of a conventional bank licensed by State Bank of Pakistan and the *Shariah* board of State Bank, In this case the opinion of the *Shariah* board of SBP will be considered final and conclusive. The reason is that the said board plays a supervisory role among all other *Shariah* advisory committees like the monitory and governing role of the State Bank of Pakistan.

²⁶⁴ Zulkifli Hasan "Shariah Governance in Islamic Financial Institutions in Malaysia" Research Paper by Faculty of *Shariah* and Law Islamic Science University Malaysia. p,14

²⁶⁵ See <http://www.sbp.org.pk/ibd/2007/Shariah-Practices-07-Aug-07.pdf> Last accessed on 07/10/2010 at 12:46 AM

4.7 *Shariah Advisor for Islamic Banking Institutions*

The State Bank of Pakistan has clearly specified a condition for the issuance of license to any Islamic commercial bank, Islamic banking subsidiary or Islamic banking branch of a conventional bank that it is required from every Islamic Banking Institution to appoint a *Shariah Advisor* meeting with the prescribed criteria of State Bank of having relevant and adequate knowledge of *Shariah*. So that he will play a significant role in ensuring *Shariah* practices in the Islamic banking Institutions hiring him. The said *Shariah* advisor should not be a director or shareholder of the hiring Islamic bank and the ruling issued by him in any financial matter concerned shall be binding on the Islamic banking Institution. He can also issue guidelines and advise on any financial matter referred to him by the board of directors or management of the Islamic banking Institution concerned.²⁶⁶

It is to be noted that for minimizing the conflict of interest, it has been clearly specified that a person can not be appointed as *Shariah Advisor* in more than one Islamic banking institution inside Pakistan. Moreover, he can not have an executive/ non-executive authority in any other financial institution. However, he can be appointed as *Sahriah* advisor of Islamic Mutual funds of the same Islamic banking institution. The *Shariah* advisors have also been barred to be hired by or having any material interest in

²⁶⁶ State Bank of Pakistan “*Draft Instructions and Guidelines for Shariah Compliance*” Para A sub Para’s v, vi.p,4

organizations. All this aimed to minimize the conflict of interest²⁶⁷ and ensure objectivity in evaluation criteria.²⁶⁸

4.8 *Shariah* Supervisory Board: An Integral Part of Internal Governance Structure

The SSB or *Shariah* Supervisory Board is considered an internal part of corporate governance framework within Islamic financial Institutions. It plays a vital role of reviewing and has to inspect that whether all the transactions, business activities and products of the Islamic financial institutions are in compliance with the guidelines of *Shariah* or not? The commercial operations of Islamic financial institutions should be in compliance with the specific rulings and guidelines issued by the *Shariah* board. The *Shariah* board may address the governance issues of this nature and present suitable solutions in the light of *Shariah* for good corporate governance in Islamic financial institutions.²⁶⁹

The Islamic Financial Services Board (IFSB) suggests that if there is no “single model” of corporate governance in every country where Islamic Financial Institutions are active; each country or each institution has to develop its own corporate governance framework. That model and every corporate governance model for Islamic Financial Institution should work in the form of deeds more than words. The logic behind this is

²⁶⁷ Conflict of interest is an issue which arises as a result of dual relationship of *Shariah* advisor with an Islamic financial institution as service provider (employee) and assessor of the business activities in the light of *Shariah*.

²⁶⁸ Islamic Banking Department SBP “Strategic Plan for Islamic Banking Industry of Pakistan” issued by State Bank of Pakistan2007 p. 23

²⁶⁹ Nidal Alsayyed “*Shariah* Board, The Task of *Ftawa*, and *Ijtihad* in Islamic Economics and Finance” M Pra Paper No 20204, INCIEF The Global University in Islamic Finance, International Islamic University Malaysia posted 22, January 2010.p,10

that good corporate governance environment can emerge only when deeds and actions will speak louder than words.²⁷⁰ Since Allah (S.W.T) also does not like the contradiction between words spoken and the actions of human beings. This fact has been stated in the Holy *Qur'an* in the following words:

"O you who believe! Why do you say what you do not do?"²⁷¹

This Verse of the Holy *Qur'an* reveals that since we are Muslims and have to follow the provisions of the revealed Holy Book, therefore deviation from the golden principles envisaged by Allah (S.W.T), in the Holy *Qur'an* is not allowed for us in any case. The theory of Islamic Commerce should be strictly observed in the operations of Islamic Banking institutions and it is the *Shariah* Supervisory Board which has to overcome the issue of gap between theory and practice in Islamic financial Institutions.

4.9 AAOIFI Governance Standard and the *Shariah* Supervisory Board

The Accounting and Auditing Organization for Islamic Financial Institution has also issued the Standard for the Governance of Islamic Financial Institutions, in which the requirement of *Shariah* Supervisory Board, its composition and report has been specified for IFIs. The said Governance Standard requires from every Islamic Financial Institution to have a *Shariah* Supervisory Board which will function as:²⁷²

- a. An independent body of *Shariah* Scholars well versed in *Fiqh almuamalat* (Islamic Commercial Law)

²⁷⁰ Ibid

²⁷¹ Qur'an 61:2

²⁷² Governance Standard ,No:1 for Islamic Financial Institutions " *Shariah Supervisory Board: Appointment, Composition and Report*" issued by Accounting and Auditing organization for Islamic Financial Institutions , 2001,p.5.6

- b. A body entrusted with the duty; to direct/issue directives, review and monitor the commercial operations of Islamic Financial Institutions to ensure the *Shariah* compliance in all the products and operations of IFIs
- c. A body which has the authority to issue *Shariah* rulings and *fatawa* which shall be of binding nature for the same Islamic Financial Institution
- d. A body which shall prepare report on that all the contracts, dealings, products and transactions of Islamic Financial Institution are confirming the rules and principles of *Shariah*.
- e. *Shariah* Supervisory Board has also been entrusted with the duty to prescribe that the allocation of profit and charging for losses (if any) in investment accounts are in conformity with the basis approved by the said *Shariah* Supervisory Board²⁷³
- f. It Shall be composed of at least three members appointed by the shareholders among those recommended by board of directors, but these member of the SSB will not include any director or shareholder of the Islamic Financial Institution and
- g. The remuneration of the *Shariah* Supervisory Board may be fixed by the board of directors if authorized by the shareholders of the Islamic Financial Institution.²⁷⁴

²⁷³ Ibid

²⁷⁴ Ibid

4.10 Composition of the *Shariah* Supervisory Board

The Governance Standard for Islamic Financial Institutions has clearly provided guidance on the composition of *Shariah* Supervisory Board. The standard mentions that the the minimum number of the members of *Shariah* Supervisory Board Shall be three. In addition to this, the board may get the services business experts, economists, lawyers, accountants and/or other experts. The standard stipulates that a director or significant shareholders shall not become the member(s) of the *Shariah* Supervisory Board of Islamic Bank.²⁷⁵

The standards issued by AAOIFI for Islamic Financial Institutions are merely guidelines for the IFIs operating in Pakistan, Saudi Arabia, Kuwait, Malaysia, Lebanon, and Indonesia. Most *Shariah* Supervisory Committees use the said standards as guidelines and therefore are not of binding nature for them. The countries where AAOIFI's *Shariah* standards are of binding nature include: Bahrain, Jordan, Qatar, Sudan, and Dubai.²⁷⁶ Hence there is need of enactment of codified law in Pakistan, Incorporated with the standards of *Shariah* Standards for Islamic Financial Institutions. This will provide a legal structure for the operations of Islamic financial institutions across the country.

²⁷⁵ Op.Cit, Governance Standard ,No:1 for Islamic Financial Institutions “*Shariah Supervisory Board: Appointment, Composition and Report*” issued by Accounting and Auditing organization for Islamic Financial Institutions , 2001,p,5

²⁷⁶ Op.Cit, Wafik, Garis Matto Pellegrini “*Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options*” World Bank Policy Research Working Paper 4052, November 2006. p,24

4.11 Qualification of the member of *Shariah* Supervisory Board

The criteria required for a member of *Shariah* Supervisory Board has been prescribed as:

1. He should be a degree holder from any recognized *Waffaqul Madaris (Dares-E-Nizami)* Eight years detailed study of *Shariah* including the study of Logic-*Mantiq*-, *Hadith*, *Tafseer*, Islamic Jurisprudence-*Fiqh*- etc). He Should Also have a minimum second class Bachelor Degree in Economics or
2. He should be be a degree holder from any recognized *Waffaqul Madaris (Dares-E-Nizami)* with specialization(*Takhassus*) in Islamic Jurisprudence and a considerable knowledge of banking and finance or
3. He should be a post graduate degree holder in Islamic Jurisprudence/ Usuluddin, LLM (*Shariah*), from a recognized university and should also be well versed in banking and finance.²⁷⁷

The above required criteria consists of both the exposure in Islamic Law and in the field of contemporary banking and finance, so that the requirements of banking institution and *Shariah* both will meet at the same time. Besides this the same member should have an experience and exposure as stated below that:

1. It is mandatory for a member of *Shariah* Supervisory Board to have experience of minimum three years of giving rulings under *Shariah* or
2. He must have five years research and Islamic banking and finance development experience and

²⁷⁷ Dr Aznan Bin Hasan “ *Optimal Shariah Governance in Islamic Finance* ” Research Paper available online http://www.bnm.gov.my/microsites/giff2007/pdf/frf/04_01.pdf Last accessed on 05/11/2010 at 3:45 PM

3. He should be efficient in the knowledge of both the Arabic and English Languages
4. The State Bank of Pakistan may, in exceptional situations, give relaxation regarding educational qualification and experience, if the person /candidate for membership is eligible for giving *Shariah* rulings regarding the matters of banking and finance.²⁷⁸ This kind of relaxation is offered in extraordinary cases where the purpose and aim may be achieved otherwise, such as his ability to give *Shariah* rulings in financial matters²⁷⁹
5. Member of the *Shariah* Supervisory Board should have a highest degree of integrity, honesty, and reputation and should have never violated any regulatory standard or requirement. He Should have never been banned from giving religious ruling (*fatawa*) by any religious authority or institution. Besides this He must be a solvent and must have financial integrity in individual capacity and proprietary capacity.²⁸⁰

To conclude, all these requirements reveal that how much a member of *Shariah* Supervisory Board should be complete in all aspects? He has to work independently without considering the fact that he is an employee of the Islamic bank. In the case where he becomes subject to such a pressure regarding his role of *Shariah* inspection and *Shariah* compliance, he should promptly communicate the issue to the *Shariah* Supervisory Board of the State Bank. The *Shariah* Supervisory Board has to make sure that all the governed Islamic banks are accountable regarding the independence of the members of *Shariah* Supervisory Board at branch level.

²⁷⁸ Ibid,p.30

²⁷⁹ Ibid

²⁸⁰ Ibid ,p.31

4.12 The Functions of *Shariah* Supervisory Board and Corporate Governance issues

The implementation of corporate governance is of great importance for Islamic Banking Institutions, since it provides a key for the success of any commercial organization. The task of ensuring good governance practices in Islamic Banking Institutions face some issues during the functioning of *Shariah* Supervisory Board. These issues which rise are mainly five, namely:²⁸¹

- I. Independence
- II. Confidentiality
- III. Competence
- IV. Consistency and
- V. Disclosure

I. The first issue is of the independence of *Shariah* Supervisory Board from management. The SSBs members are generally appointed by the shareholders of the banking institution; the board of directors represents them. They are employees of the institution and therefore management approves their remuneration which is approved by the board of directors. It manifests the dual relationship of the SSB members with the banking institution as service providers and commercial activities evaluators/inspectors. This could cause for the conflict of interest.²⁸²

²⁸¹ Op.cit Wafik, Garis, Matto Pellegrini "Corporate Governance in Institutions Offering Islamic Financial Services: Issues and Options" World Bank Policy Research Working Paper 4052, November 2006. p,20

²⁸² Ibid

II. The second issue – the issue of confidentiality- arises when the *Shariah* scholars sitting on more than one *Shariah* Supervisory Board of different Islamic financial Institutions. In this case the proprietary information of competing institutions may be leaked out.²⁸³ But *Shariah* Board of the State Bank of Pakistan has clearly prohibited this practice by debarring *Shariah* advisor from having membership of more than one *Shariah* board.

III. The issue of competence arises regarding the performance of the *Shariah* Scholars. They are required to be well-versed with both Islamic Law and financial matters. But practically a very few number of them are fulfilling this requirement.²⁸⁴ This issue may be solved by arranging very comprehensive sort of training for them in the field in which they are required to get more expertise and knowledge. Such training arrangements may be provided by the hiring institution and the *Shariah* Scholars should only be assigned duties after their competence in both the fields.

IV. There is need of consistency of judgments across Islamic Financial Institutions. Different opinions on a single transaction or financial instrument hurt the investors and affect the enforceability of contracts.²⁸⁵ This issue can be resolved by the way of choosing an opinion among various opinions presented by various schools of thought. Such as the methodology adopted by prominent *Shariah* Scholars of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), in which the opinions of various Schools of thoughts are analyzed keeping in view public interest and then an agreed opinion is presented and compiled in the shape of *Shariah* Standards

²⁸³ Ibid

²⁸⁴ Ibid

²⁸⁵ Ibid .p,21

(SSs) for Islamic Financial Institutions. A structure if consistency of opinions, is therefore required to be developed, acceptable to the customers of Islamic financial institutions.

V. The last issue which is pointed out is that of disclosure. There is need of disclosure of all information relating to advisory role of a *Shariah* advisor. This would certainly give the impression of strong credibility that the services of Islamic financial institutions are completely different from conventional ones and lead to the promotion of market discipline.²⁸⁶ All these issues are debatable and are required to be addressed by the *Shariah* board of AAOIFI and other bodies which are the main role player for regulating the business of Islamic financial institutions across the globe, since the guidance is provided by this organization for regulating the business activities of these institutions in the light of *Shariah*. The *Shariah* Supervisory Board of the state bank of Pakistan has to address these issues and those related to the practical procedure applied in Islamic banks, one by one and must provide a firm solution for attracting the confidence of customers and ensuring *Shariah* compliance in the operations of Islamic banks across the country.

²⁸⁶ Ibid

4.13 Corporate Governance model of Islamic Banking Institutions in Pakistan

The study of literature regarding the subject under discussion reveals that Pakistani Islamic Banking Institutions adopt the corporate governance model as:

1. The *Shariah* Board at the central level (State Bank) is the governing body for regulating the business activities of Islamic Institutions in Pakistan. The said board has issued the directives for licensed Islamic Financial Institutions.
2. The requirements for the appointment of Suitable and eligible *Shariah* Advisor are issued by the *Shariah* Board of State Bank considering the Standards issued by AAOIFI in this regard.
3. It is permissible for the member of State Bank's *Shariah* Board to be appointed as *Shariah* Advisor of an Islamic Financial Institution.
4. A *Shariah* Advisor of one Islamic Financial Institution can not be appointed as *Sahriah* advisor by any other Islamic Financial institution in Pakistan.

CHAPTER 5

CONCLUSION

The research is aimed to examine the practices of corporate governance in Pakistan in the light of principles provided by *Shariah*. In this respect certain issues pointed out discussed, were the lack of Islamic values, i.e *Shariah* Audit, Accountability, trustworthiness, transparency and other moral and ethical standards. The application of this concept in the Pakistani Islamic financial institution was also discussed.

Chapter number one discussed different concepts related to corporate governance like its definitions, its importance, its history, its principles, the role of organization for economic and cooperation development (OECD) and role of directors, managers, auditors and shareholders in governance mechanism. It was discussed that this new idea is of great importance for running the corporations, financial institutions and other business entities in accordance with the prevailing regulations and principles. This definitely results in the prevention of fraud, direct and personal interventions and strengthens the institutions in terms of their reputation, customer's confidence and protection of all the shareholders.

It was pointed out that the western corporate governance mechanism could not eliminate the principle agent (agency problem) problem completely. The reason is that the western framework could not issue affective and binding regulations in this regard. The agency problem arises when the interests of agent and principle conflict each other. The presumption is that principal generally hires the agent to achieve his own interests.

The same chapter also discussed the principles of corporate governance formulated by the Organization for Cooperation and Economic Development. Those principles are reflecting the idea which is there in the various definitions of the term"

“corporate governance” like the relationship between shareholders, managers and the directors of a corporation which is governed and regulated for achieving the interests of corporation and protection of the shareholder’s rights.

It was concluded in the light of crisis which has been faced by a number of economies and business organizations that corporate governance adopted the status of back bone for business organizations and country’s economic growth. The developing countries, like Pakistan, have to take affective steps to achieve the observance of good and affective corporate governance practices in their public sector business organizations and also in private companies.

Chapter number two discussed and examined the framework of corporate governance applied in Pakistan. The Rules, regulations and Laws enacted in Pakistan have been discussed in detail. The assisting role of Asian Development Bank (ADB) United Nations Development Program in the implementation of capital market reforms paved a way to ensure that steps to be taken for good governance practices in Pakistani corporations. Although the literature regarding corporate governance in Pakistan is thin but the international literature, reports and corporate governance codes like Cadbury Committee’s Code on the Financial aspects of Corporate Governance published in December 1992, Hampel Committee’s Report 1998, OECD Principles of Corporate Governance 1999 and the King Report’s Recommendations (South Africa) have been utilized by the Security and Exchange Commission of Pakistan (The main role player in regulating the activities of corporations in accordance with code of corporate governance and international best practices). This governing body named Security and Exchange Commission of Pakistan is governed by the SECP Act, 1997. This body governs a

number of Laws such as the Companies Ordinance 1984, The *Mudarabah* (Floatation and Control) Ordinance, 1980 and The Securities and Exchange Ordinance, 1969. The scope of SECP has been also discussed that it issues regulations binding on all listed companies and a number of derived reforms from international best practices of governance have been implemented such as : the vital role assigned to the non-executive directors, steps for strengthening the rights of minority shareholders (although certain other steps are required to redress their grievances caused by the management inside the company) and ensuring transparency, accountability and broad representation.

A number of Laws and provisions applicable to corporate governance mechanism working in Pakistan have also been discussed such as: corporate laws, regulations and rule falling under corporate laws, the bye laws, the applicable provisions of general criminal law and civil laws. The special prosecution of those who commit fraud, corruption and misappropriation under National Accountability Ordinance 2007, governing and regulatory provisions incorporated in Companies Ordinance 1984 such as: provisions aimed to prevent Conflict of Interest and promote transparency and provisions aimed to ensure disclosure and fair accounts in corporations, have been discussed in detail.

Finally the key governance issues faced by Pakistan and the need for incorporation of a comprehensive Code of Corporate Governance based on the general business principles of Islamic Law has been made the subject of discussion. The key issues such as: Lack of mechanism to protect the minority shareholders against the infringement of their rights by management, conflict of interest (i.e. awarding contracts to favorites double book keeping to avoid taxes), lack of legal expertise in audit committee

and lack of ethical standards in companies are still needed to be considered for bringing future reforms in corporate governance mechanism of Pakistan.

Chapter number three discussed the Idea of corporate governance from the perspectives of *Shariah*. It elaborated further that *Shariah* governance of institutions mainly aims to regulate the affairs of management, establish a *Shariah* supervisory board working under the principles of *Shariah*. Although the terminology of corporate governance may be new to some Muslims and could be a modern conceptual creation, but the idea is not new to Islam. Muslim Scholars elaborated the Idea as: it aims to ensure fairness to all the stakeholders, to be attained through greater transparency and accountability.

The various verses of the Holy *Qur'an* are evident that the values, norms and principles of governance are not alien to Islam. The associated values of corporate governance: such as *Shariah* Audit, Accountability, Transparency and Trustworthiness are the main factors necessary for governing a business entity in compliance with *Shariah*. The right of man's ownership is not absolute but God is the ultimate owner of wealth. Therefore Islam emphasized that human beings should continuously act and make decisions regarding the management of wealth, property and environment based on equality, truth and justice. The concept of transparency (*Al Shafafiyah*) which has been based on the phenomena of Accountability (*Ihtisab*) and *Hisbah* has also a great concern with the governance idea in corporations and business entities. Allah (S.W.T) Has mentioned it clearly in the Holy *Qur'an* that:

“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...”²⁸⁷ This verse provided a base for transparency in transactions. Transparency in this context involves accuracy equality, fairness and just system.

The role of board of directors, auditors, and management, their duties and responsibilities towards the business organization, shareholders and other stakeholder have been extracted from the basic values of governance prescribed in Islam.

The need for a codification has been pointed out, which will declare all the non-*Shariah* business activities of public, private organizations to be illegal in the eye of *Shariah*. Such a codification should be based on the idea of Islamic Governance which will provide for the revision of business organization’s transactional conformity with the paramount principles of *Shariah*. Finally a summary of affective *Shariah* governance principles has been mentioned. This summary has been derived after making a comparison between the OECD principles of corporate governance and Islamic Principles. It has been stressed that moral standards and boundaries of *Shariah*, Profit and loss Sharing principle (*Al kharaj Bi Dhamaan*), prohibition of *Riba* (Interest) and considering the capital as Allah’s trust, should be the basis for governance system for business entities operating in Muslim countries.

Chapter number four discussed and examined the practical steps taken by the Pakistani Islamic financial institutions for the implementation of the Islamic Idea of corporate governance. The term “corporate governance” is defined from banking perspective, but from the Islamic banking perspective there is no solid definition. An effort has been made to define the term from Islamic banking perspective by analyzing the definition of the term from banking perspective and studying the principles of

²⁸⁷ Qur'an 2:282

corporate governance in *Shariah*. Thus I have tried to come up with a new definition as: "From the Islamic banking perspective, corporate governance involves the manner in which the affairs of the banking management are regulated, the business and affairs of individual Islamic financial institutions are governed by the *Shariah* Supervisory Board established according to the spirit of *Shariah* affecting how banks: have tried to come up with a new definition as:

- a. Set corporate objectives in compliance with *Shariah*
- b. Run the day-to-day business activities according to the Islamic business principles
- c. Consider the interests of stakeholders recognized by *Shariah*
- d. Align corporate activities and behaviors with the expectations that Islamic banks will operate in safe and sound manner, and in compliance with applicable *Shariah* compliant laws and regulations and
- e. Protect interests of the depositors

In my humble opinion this definition may be called a comprehensive definition from the Islamic banking perspective as it covers all the essential elements essential for governance of Islamic financial institutions. The importance of corporate governance has been prescribed for Islamic finance and it has been pointed out that Islamic financial industry is really in need of good governance mechanism since this industry grows rapidly across the globe. This industry is an integral part of the word's economic system and it needs to be governed under the principles of *Al-Kharaj bil-daman* (Entitlement to Profit is based upon the liability for bearing the loss, Prohibition of *Riba* (Usury), Faith based approach (running this industry under the principles of *Shariah*) and Profit-motive,

that gives a legal status to the trade and commercial transactions and maximization of shareholder's capital.

There is a glance on the historical background of *Shariah* Governance in Islamic Banks and the role of State Bank of Pakistan has been elaborate in governing the Islamic banks in Pakistan. The Islamic banking department of this governing bank and *Shariah* Supervisory Board of SBP issues guidelines and policies for regulating the business activities of Islamic banks considering the standards issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), principles issued by Organization for Economic Cooperation and development (OECD) and Islamic Financial Services Board (IFSB). These guidelines require a *Shariah* supervisory board from every Islamic financial institution and a *Shariah* advisor on branch level. The fit and proper criteria has been prescribed by these guidelines issued by the SBP for the appointment of the member of *Shariah* board and *Shariah* advisor and deviation from these guidelines may cause for the cancellation of license issued to operate as an Islamic financial institution.

Certain issues arising during the functioning of *Shariah* Supervisory Board have been pointed out and the steps or suggestions to resolve these issues have been discussed. These issues are: independence of the board members, confidentiality of bank's secrets, and competence of the board's member, lack consistency in judgments or opinions and disclosure. Finally an overall sketch of corporate governance model working in Pakistan for regulating the operations of Islamic financial institutions has been presented. This is the overall conclusion of this research study.

RECOMENDATIONS

The following measures can be suggested in the light of this research work:

1. The way corporations are being governed in Pakistan should not merely aim maximizing profit or efficient economic growth, but the corporate governance mechanism applied in Pakistan should also assure that corporations and financial institutions are governed and controlled in accordance with highest degree of moral and ethical standards acceptable to the general public.
2. The Security and Exchange Commission of Pakistan (SECP) should consider the Islamic general business principles in the code and direct all the listing companies to comply with these general principles.
3. Although the SECP considers that the desired way for the promotion of the interests of all the stakeholders is to ensure that the business is run and the corporations are managed in accordance with the highest prevailing standards of ethics.²⁸⁸ But the issue here is that whether the “high ethics” are in conformity with the business principles and rules laid down by Islam or not? The position of Security and Exchange Commission of Pakistan is ambiguous here, whether the duties assigned to it are based common law or purely on Islamic Law. The business ethics for the corporate governance in Pakistan are seriously required to be based on those prescribed by Islam and the gap between theory and practice of the corporate entities must be eliminated in this regard.
4. A *Shariah* based code of corporate governance should be incorporated for regulating the business activities of Pakistani corporations according to the

²⁸⁸ See Sec.& Exchange Commission of Pak “*Manual of Corporate Governance*” Paragraph 2.1

principles prescribed by *Shariah* for business and corporate activities. This will hopefully help in achieving the required level of transparency and accountability in corporate culture of Pakistan.

5. It is also hoped that after the final judgment of the Supreme Court in case of *Riba*, the government of Pakistan and the State Bank of Pakistan will take immediate action for the eradication of all sorts of *Riba* from the business of corporation and banking sector in Pakistan.
6. Microfinance is also an emerging aspect of the Islamic Financial Industry working in Pakistan. Therefore good governance practices are required to be assured for attaining the confidence of customers and those who have concern with it.
7. As far as the Islamic banks in Pakistan are concerned, the government of Pakistan should act as a regulatory body and the State Bank may be directed to issue the *Shariah* based governance regulations required to be strictly implemented by each and every Islamic Financial Institution for an affective *Shariah* governance. The Islamic banks should play the role of implementer, and also other individuals who may have a concern with the business of Islamic banks, such as auditors, accountants and lawyers.
8. A comprehensive Islamic Banking Code/Law should be enacted and promulgated for the elimination of *Riba* (usury) from the banking sector in Pakistan and for giving a stronger legal status to the Islamic financial institutions across the country. This will provide a legal forum for dispute resolution between the

customer and Islamic financial institution, and between Islamic financial institutions as well.

9. The dispute settlement mechanism for Islamic Financial Institutions is also needed for the improvement of Islamic Financial Industry in Pakistan. This may include the establishment of Islamic Banking Tribunals across the country, where the services of Islamic Finance experts may be hired for resolving the disputes.

IN THE END, ALL PRAISE IS DUE TO ALLAH (S.W.T), LORD OF ALL THE
WORLDS!

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