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Corporate Governance and Stakeholder Management of Islamic Financial Institutions

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ABSTRACT

Sound corporate governance practices have become essential for efficient, viable and sustainable growth of Islamic wealth management services. Accordingly, there is a shift from the traditional shareholder value centred view of corporate governance in favour of a corporate governance structure that looks after the interest of a wider circle of stakeholder. Extant literature suggests that a good corporate governance practices depends on how well companies manage the diverse expectations and interests of various stakeholder groups. Nevertheless Western scholars have noted that constructing a model to devise a principle for making trade-offs among diverse stakeholders is the toughest problem of ethics that usually emerged. For Islamic financial institutions, this issue becomes more acute especially when corporate governance objectives would include reassuring stakeholders that they are likely to receive a fair return on their investments and equally important, that the business practices are in conformity with Shariah. This paper, therefore attempts to address this issue by providing Shariah prescription that provides a framework for managers to resolve problems arising from potential conflicting responsibilities towards various stakeholders. In particular, the pyramid of *maslahah* may serve as a viable and effective model to devise a decision framework for managing conflicts and interest of various stakeholder groups.

INTRODUCTION

Islam as a way of life has always promoted good ethics, strong morals, unshakeable integrity and honesty of the highest order. These positive values and high ethical conduct have firmly inbuilt and inherent in the Muslim community. Therefore the issue of Corporate Governance (hereafter as CG) as widely discussed in the West today is not foreign to Islamic financial institutions. As organisations governed by the principles laid out in Islam, Islamic financial institutions must strictly observe and fulfil their obligations as prescribed by the Islamic Law of Shariah.

Apparently, the issue of CG has started to figure prominently in public domain in the wake of increasing notorious mismanagement scandals involving different types of corporations including financial institutions like Barings and Bank of Credit and Commerce International (BCCI). Even for institution that proclaims itself as 'Shariah-compliance' is not immune from this mishap. The collapse of Ihlas Finance House (IFH) of Turkey in 2001 provides an example how weakness in CG practice entails negative repercussion for soundness and sustainability of an Islamic financial institution (Jang 2003).

It is now commonly acknowledged that consequences of weak CG are not only financial, but also social, environmental and essentially human damages. Accordingly, there is a shift from the traditional shareholder value centred view of CG in favour of a CG structure that looks after the interest of a wider circle of stakeholder. Extant literature suggests that a good CG practices depends on how well companies manage the diverse expectations and interests of various stakeholder groups. Nevertheless Western scholars have noted that constructing a model to devise a principle for making trade-offs among diverse stakeholders is the toughest problem of ethics that usually emerged {Donaldson, 1995 #26}{Donaldson, 1999 #22}{Boatright, 1993 #53}.

This paper, therefore attempts to address this issue by providing Shariah prescription that provides a framework for managers to resolve problems arising from potential conflicting responsibilities towards various stakeholders. In particular, the pyramid of *maslahah* may serve as a viable and effective model to devise a decision framework for managing conflicts and interest of various stakeholder groups.

This structure of the paper is as follows. Section 2 offers a brief overview of recent phenomenon in CG especially the paradigm shift from shareholders' value based CG to stakeholders' value based CG. Section 3 reviews the stakeholder theory as a context for the main themes of the paper. Section 4 offers an Islamic perspective on the stakeholder theory. Section 5 discusses the Islamic principles of *maslahah*

and the trade-offs that can exist in managing different needs and interests of diverse stakeholders. This is followed by a more detailed discussion of the pyramid of maslahah as a framework for stakeholder management. A brief overall summary is offered in final section.

A SHIFT FROM SHAREHOLDERS' TO STAKEHOLDERS' VALUE BASED CG

The conventional approach of CG has been mainly focusing on principal-agent relationship between managers and shareholders (investors/owners) of corporations. The basic features of this model are that the shareholders (principals) delegate the task of management to managers (agents) who, in theory, act in the interests of the shareholders. However this is not always be the case especially in the presence of agency problem.

Agency problem is deemed to exist when managers have information advantages over shareholders and also have their own interests which may not correspond with those of the owners. In other words, when one tries to maximise its own interests at the expense of others, an agency problem is said to exist between them. The issue of agency problem has been widely discussed in finance literature. Basically, an agency problem arises from adverse selection and moral hazard behaviour. The former is related to uncertainty and the prohibitive transaction costs required in selecting the right transacting parties in the face of limitless contingencies in the business environment. Moral hazard on the other hand describes opportunism or self-interest that includes subtle and devious behaviour known as self-interest seeking in guile (Williamson 1985).

On the whole, the shareholders' value based CG mainly deals with mechanisms and arrangements to protect shareholders' interests. According to Llewellyn (2001) CG arrangements include issues of corporate structure, the power of shareholders to exercise accountability of managers, the transparency of corporate structures, the authority and power of directors, internal audit arrangements and lines of accountability of managers. In the final analysis, the essence of shareholders' value based CG is the design of incentives that lead managers to pursue the maximisation of shareholders' wealth. Based on this premise, the fundamental question of CG is how to protect shareholders' interests effectively and efficiently

While the shareholders' value has become the most popular perspective in Western CG literature, there is now a strong movement toward a broader stakeholders' model of CG. Even the policy makers have adopted stakeholders' value of CG in constructing Best Practices and codifying principles related to CG. For example, Organisation for Economic Cooperation and Europe (OECD) has recently proposes a definition of corporate governance as *"a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined"* (OECD, 2004).

Tirole (1999) asserts that the need to consider other stakeholders besides shareholders is imperative, especially when the managerial decisions do not only impact the investors but also exert externalities on a number of natural stakeholders who have an innate relationship with the firm. This is particularly true when more often than not, stakeholders especially parties who do not have any contractual relationship with the firm are the one who normally would be affected by the externalities of its decision. For example, communities downstream of a new dam project may be affected by biodiversity damage of their environment.

Tirole's view on the importance to broaden the circle of stakeholders has been thoroughly discussed in management literature. Donaldson (1992) traces the usage of term 'stakeholder' to the writings of Robert K. Merton in 1950s and has enjoyed a vogue in recent years. The Stanford Research Institute, in 1963 (as quoted in Kitson and Campbell, 1996) defined the stakeholder as those groups without whose support an organisation would cease to exist. Its list of stakeholders originally included shareholders, employees, customers, suppliers, lenders, and society. It was argued that unless business executives understood the needs and concerns of these stakeholder groups, they would be unable to secure the support necessary

for the continued survival of the firm. Freeman (1984) widens the definition to “any group or individual who can affect or is affected by the achievement of the organisation’s objectives.”

Generally the proponents of this stakeholder view posit that paying attention to the interests, needs and rights of multiple stakeholders of a business is a useful way of inculcating socially responsible behaviour among corporations¹. Freeman (1984) distinguishes between primary stakeholders (owners, management, local community, customers, employees and suppliers), those whose continuing participation is necessary for the survival of the corporation, and secondary stakeholders (the government and communities that provide infrastructure and markets, trade unions and environmentalists), who are not essential to the survival of the corporation although their actions can significantly damage (or benefit) for the corporation.

STAKEHOLDER THEORY

Literature on the stakeholder theory can be divided into three categories: descriptive, instrumental and normative. The descriptive approach to stakeholder theory describes and explains actual corporate behaviours and characteristics with respect to its stakeholder relationships. The proponents of this strand posit that the nature of an organisation’s stakeholders, their values, their relative influence on decisions and the nature of the situations are all relevant in order to predict organisational behaviour. Furthermore this view asserts that managers behave as if stakeholders mattered because of the intrinsic justice of their claims on the firm².

The instrumental view focuses primarily on the impact that the stakeholder may have in terms of corporate effectiveness. It posits that adherence to stakeholder management principles may result in positive outcomes on the achievement of various corporate performance goals. According to this view, the performance of the firms encompasses more than financial performance alone. It ultimately depends on the ability of firm to manage the interests and expectations of various stakeholders effectively and efficiently³. Jones (1995), Murray and Vogel (1997) and Ruf, Muralidhar et al. (2001) assert that if firms contract with their stakeholders on the basis of mutual trust and cooperation, they will have a competitive advantage over firms that do not. Numerous empirical studies have been conducted to analyse the correlation between the stakeholder approach and corporate performance employing conventional measures of corporate performance and a broader measure such as corporate social performance⁴.

A different approach in justifying and illuminating stakeholder theory is provided by the normative strand. This view proposes narrative accounts of moral behaviour and philosophical guidelines for the operation and management of corporation in a stakeholder context. In other words, the studies attempt to explain what the firm ‘ought to do’ both in terms of the ends it pursues and the means it utilises, as well as why these ‘ought to’s are appropriate. Recognising the existence of different stakeholders, this view obligates corporations to take the interests of all the groups into account. Hence, morally significant values are essential to effective management decisions. For example, if consumers have a right to products that are unlikely to cause serious injury, then corporations are obligated to take into account this group in making decisions about product design. Similarly if employees have a right to a safe and healthy workplace, the corporations need to consider this stakeholder group in making decisions about work routine and workplace conditions.

They also contend that the ethical management of stakeholder relations makes good business sense; the long-term interests of stakeholders and shareholders are compatible. An organisation that acts ethically and morally will be trusted by its stakeholders, and is therefore expected to establish cooperative

¹ Refer to Goodpaster (2001), Greenwood (2001), (2001), Ruf, Muralidhar, et al. (2001), Dawkins and Lewis (2003), Maignan and Ferrell (2004).

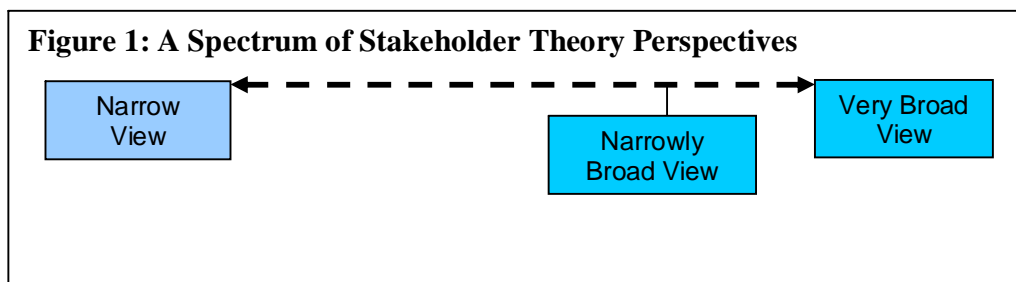
² For a detailed discussion on descriptive stakeholder theory, refer to Brenner and Cochran (1991), Jones (1994), Jones and Wicks (1999), Delmas and Toffel (2004).

³ Refer to Cochran and Wood (1984), Cornell and Shapiro (1987), Barton, Hill, et al. (1989), Kotter and Heskett (1992), Berman, Wicks, et al. (1999).

⁴ See in Carroll (1979), Wartick and Cochran (1985), Wood (1991).

relations easily. These conditions of mutual trust and cooperation between an organisation and its various stakeholders are deemed to reduce contracting costs, resulting in more efficient transactions, hence granting the corporation with competitive advantage over firms that do not adhere to the stakeholder principles⁵.

On the whole the stakeholder theory has been used extensively to illuminate the constructs of corporate governance. The theory delineates corporate governance by emphasising on a firm's responsibility to a broader circle of stakeholders. It shifts from the traditional 'shareholder value centred' in favour of a corporate responsibility that looks after the interest of a wider circle of stakeholders including employees, customers, consumers, investors, local communities and others. Figure 1 illustrates the various positions and views of CG taking into account the stakeholder theory perspectives. The narrow view represents the restricted view of corporate responsibility to that of the shareholder, while the broad view highlights the position of stakeholder theory.



On one side of the spectrum (as depicted in Figure 1), is the narrow view, representing classical strand advocated by Friedman (1967; 1996), argues that the sole responsibility of business is to make a maximum profits. The proponents of this view posits that manager has only one fiduciary obligation – to use resources supplied by its shareholders and to engage in activities designed to increase profits on their behalf. They contend that obligation of managers to other stakeholders (employees, customers and communities) is morally significant, but they are non-fiduciary obligations. Hence, treating obligations to shareholders and stakeholders alike, according to them, is to obscure an important distinction between them (Friedman 1967, 1996; Goodpaster 2001).

As the spectrum moves towards the right, the doctrine of stakeholder value based CG emerges broadening the classical definition of business responsibilities. It takes into account the multi-fiduciary role of a firm by recognising firm's responsibilities that go beyond shareholder-management relationship. In this context, the management sees itself as being responsible for satisfying and meeting the demand of the multiple stakeholder interests. More specifically, as depicted by the narrowly broad view, firms have social responsibilities to various groups that have direct financial connection with them: consumers, employees, shareholders, and suppliers (Freeman 1984). Moreover, as the spectrum moves further to the extreme right, the very broad view extends the definition of stakeholders to include society at large and other relevant stakeholder groups. The reason for extending the firm's social responsibility to include all possible effects on society, according to this view, is that firms, especially big corporations, have great economic and social power. Therefore, in return for granting companies their legal status as separate entities, society is entitled to expect from them a significant net positive contribution for the general good (Greenwood 2001).

Despite the many attempts to justify the stakeholders' value of CG, it remains open to criticism for its inherent problems relating to justification, conceptual clarity and possible inconsistency. Western scholars are lacking in consensus on how to construe a firm's duties towards stakeholders without dismissing the

⁵ For a detailed discussion of the arguments on how ethical management of stakeholder relations can actually reduce transaction costs and other agency problems, and eventually enhance competitiveness, refer to Preston and Sapieza (1990), Hill and Jones (1992), Boatright (1993), Jones (1995), Key and Popkin (1998), Ruf, Muralidhar, et al. (2001).

moral and ethical components, i.e. the normative accounts. Goodpaster (2001) and Humber (2002) argue that corporations have to be allowed to construe their duties to stakeholders along virtually any line they wish⁶. This line of argument can be traced to the philosophical study of morality based on ethical relativism which promotes the individual as the only source of moral judgement while denying any objective or absolute moral values that are common to all people and times. The ethical relativism further argues that all moral values are largely determined by circumstances or social environment. Hence, there can be no absolute goodness or absolute evil in a relativist society (Ahmad 2003)⁷. Writers also find it difficult to draw a clear line between who really is an actual stakeholder and who is not.

ISLAMIC PERSPECTIVES ON THE STAKEHOLDER THEORY

The Islamic perspectives on the stakeholder theory to the contrary, provide a more enduring and solid justification regarding who can qualify as a stakeholder and what are the rights and responsibilities that both firms and their various stakeholders may assume. This framework is firmly established in Islamic principles of property rights and contracts. According to Iqbal and Mirakhor (2003; 2004) and Iqbal and Molyneux (2005), a stakeholder is defined as the one whose property rights are at stake or at risk due to voluntary or involuntary actions of the firm. This implies that the firm is expected to preserve property rights of not only the shareholders but also those who have participated in the process of acquiring or earning the firm's property, and those who could be threatened as a result of the firm's operation. They also posit that any group or individuals with whom a firm has any explicit and implicit contractual obligations qualifies as a stakeholder even though the firm may not have formal contracts with them through mutual bargaining.

Indeed, the Islamic framework of contract places equal emphasis on obligations arising from both explicit and implicit contracts. The former is clearly stipulated in the Islamic law of contracting that normally includes provisions that seek to protect the interest of parties involved in transactions. However, the law cannot take into account all the externalities incurred as a result of the firms' operation. In this respect, Islamic framework of contract and property rights obligates firms to honour the implicit contracts or 'unwritten codes of conduct' to the various stakeholders who might be affected by the firms' actions (Iqbal and Molyneux 2005).

These implicit contracts are more enduring since it is governed by the Shariah. In fact according to Al-Attas (2005), the implicit contract is actually a divine contract that requires man to manifest the covenant (al-mithaq) through his submission in absolute true willingness as prescribed by the Divine Law of Shariah. Indeed, the very foundation of the Shariah is covenant between God and man which imposes on man the duty of being faithful to his Lord. Failure to fulfil these obligations means he or she has breach the Divine contract, thus tantamount to betrayal with all the attending consequences in this world as well as in the hereafter.

⁶ According to Goodpaster (2001), the paradox is the result of contradictory duties of the managers to various stakeholders that can result in "business without ethics" if the shareholders' interests are given priority, and "ethics without business" if other stakeholders' interests are served at the expense of profits. He further argues that the use of the stakeholder analysis does not necessarily imply ethical behaviour. In contrast, he contends that stakeholders' approaches are neutral so that their ethical applications are contingent on the managers' behaviour. See detailed discussion in Goodpaster (2001), Humber (2002). Again this argument is in line with the Friedman and other classical theoreticians.

⁷ According to Ahmad (2003), the proponents of ethical relativism often use cultural variability to support their theory and argue that culture usually defines morality. Ahmad further cites an interesting quotation made by the renowned American psychologist, B.F. Skinner who stated:

"What a given group of people calls good is a fact; it is what members of the group find reinforcing as the result of their genetic endowment and the natural and social contingencies to which they have been exposed. Each culture has its own set of goods, and what is good in one culture may not be good in another. To recognise this is to take the position of "cultural relativism". What is good for the Trobriand Islander is good for Trobriand Islander and that is that." See in Ahmad (2003).

A person's relationship with his God should, by right, determine the mode of relationship with his fellow servants and not vice versa (Hasan 2002; Ahmad 2003). The relationship and responsibility between man and his Master is in fact an actual and real contract stipulated by the so-called Divine contract. This philosophical foundation of the Islamic society will avoid conflicting interests among members of the society, since everyone has a unity of purpose in his life, that is to serve Allah (Ahmad 2003). This will inevitably lead to a society whereby every member will cooperate with each other rather than compete, as success in life is to obtain the ultimate happiness (*falāh*).

Furthermore, guided by the proper relationship with God, the person's daily interactions and transactions would be inspired by the values of truthfulness, firmness, fairness, respect for the law, kindness, forbearance, tolerance and uprightness, instead of deceit, haughtiness, class consciousness, ostentation, insubordination, envy, jealousy, backbiting and self-aggrandisement (Hasan 2002). This should naturally be manifested in individuals' involvement in business activities and operations as well as their relationships with all their respective stakeholders.

For a devout Muslim, concern for others and the environment he lives in, is deeply inscribed in the pillars of Islam, binding on every Muslim⁸. Therefore, concern for aggregate welfare of stakeholders is a moral and religious initiative based on the belief that a company should be "good" regardless of its financial consequences, be it positive or negative. This is not to suggest that Islam is against profit-making. Rather, it is seen as a necessary condition, though not the sole purpose, of their existence (Hasan 1983). The invocation of Shariah in business imply that the entrepreneur is no longer driven by the principle of profit maximisation alone, but by the pursuit of the ultimate happiness in this life and the Hereafter, whereby he acknowledged his social and moral responsibility for the well-being of his fellowmen (e.g. consumers, employees, shareholders and local communities).

Hence, it is an obligation on the firm to preserve sanctity of implicit contracts by recognising and protecting the property rights of all relevant stakeholders such as customers, consumers, suppliers, employees and local communities. These property rights by and large are granted and preserved by Shariah to promote social order and economic development (Iqbal and Mirakhor 2004).

The firms must not violate in any way the property rights of those with whom they interact. For example, Islam recognises 'self-interest' and permits 'profit-motive' as these are natural motivating forces in all human life. But self-interest has to be linked to the overall concepts of goodness and justice, which require the preservation of society's well-being and interests. In other words, firms may strive to maximise their shareholder's wealth as long as they do not create a situation that is socially disruptive or in violation of the norms of Islamic justice. This in fact contradicts the doctrine of self-interest idealised in neoclassical economics.

These arguments are parallel to the earlier writings by scholars like Chapra (1985, 1992, 2000); Metwally (1997); Kuran (1995) and others, who correctly assert that while Islam recognises private ownership extending to various means of production, the right of private ownership in Islam is however, not absolute and unconditional. The reasons are twofold: Firstly, private ownership in Islam is subject to the interest of the community. Secondly, with regard to the means of acquiring ownership or property rights, Islam totally prohibits earning income through illegitimate means such as production and sale of alcoholic substances and pig products, usury, gambling, black marketing, dispute, deceptive purchases, any form of hoarding and conducting business in the manner harmful to the cause of the people.

⁸ A Muslim is, in fact, considered as a social being who cannot isolate or ignore his role and responsibility to the society or any of his fellow human being such that he is discouraged to isolate himself even for the purpose of worshipping God. A beautiful hadith justifies this argument when the Prophet Muhammad (peace be upon him) once narrated by Abu Hurayrah who said:

One of the Prophet's Companions passed a ravine where a freshwater spring ran. He liked the ravine and said, "How I would like to isolate myself from other people to worship Allah! I will not do so before asking permission from the Messenger of Allah (peace be upon him)." The man told the Prophet of his wish, and the Prophet said, "Do not do it. Your striving for the path of Allah is better than Praying in your house for seventy years." (Narrated by Tirmidzi and al-Hākim.)

Moreover, since the Islamic concept of justice denotes a balance of the forces of equilibrium, a firm with a better financial position has the moral commitment and social responsibility to be concerned with the less-fortunate segment of society, like the poor, by paying compulsory zakah and/or giving voluntary donations (sadāqah). Similarly, appropriate measures should be taken for safety and security in workplaces, particularly in protecting the interest of the employees. According to Islam, the technique of “cooperative forces” and not the technique of “opposites” should be used in achieving the equilibrium in different fields (Metwally 1997)⁹. Hence, the Islamic framework of stakeholder strives for a balanced and harmonised interest of various stakeholder groups based on the moral and ethical principles enshrined in the Divine guidance or Shariah.

Consequently, the Islamic norms and values that characterise each organisation will have an effect on whether and how the concept of the stakeholder might be used, particularly in managing CG issue. In this sense, there is a normative core grounded to the Islamic moral and ethical principles for the use of the stakeholder concepts. Thus, the Islamic principles provide a coherent justification framework particularly in solving the problems of identifying who is and who is not a stakeholder as well as recognising and justifying the rights of different stakeholders which many of the humanistic-based moral theories fail to make sense.

MANAGING CONFLICT AMONG STAKEHOLDERS

Many Western scholars like Donaldson (1995, 1999), Boatright (1993) and others have noted that constructing a model to devise a principle for making trade-offs among the stakeholder groups is the toughest problem of ethics that usually emerged. Public policy overcomes the limits of available analytical frameworks to deal with diverse stakeholders’ interests and needs by adopting pragmatic approaches. This corresponds to the arguments posed by Goodpaster (2001) and Humber (2002) who assert that corporations have to be allowed to construe their duties to stakeholders along virtually any line they wish.

OECD for example came out with a very broad definition of CG that does not actually deal with the intrinsic issue of the business objectives that should be determining for the distribution of rights and responsibilities within the corporation. In essence, firm’s objectives determine how to deal and manage needs and interests of diverse stakeholder groups. Hence, it would be expected that the distribution of rights and responsibilities among shareholders and stakeholders would be driven by the interests of whoever establishes the corporation and subsequently controls it.

The concept of governance in Islam on the other hand, which is based on stakeholder-oriented model, provides a concrete framework to determine the optimal way for the distribution or rights and responsibilities of various stakeholders. As discussed earlier, Iqbal and Mirakhor (2004) describes the governance structure of an Islamic financial system protect the rights of all stakeholders who are exposed to any risk as a result of the firm’s activities. The Islamic principle of property rights and contracts protects the rights and responsibilities of various stakeholder groups. Furthermore Islam also provides a framework in delineating priorities in human endeavour. In particular the principles of *maslahah* has been used throughout Muslims history to protect and resolve problems arising from the potential conflicting rights and responsibilities in different fields.

PYRAMID OF MASLAHAH

Before discussing the application of *maslahah* in stakeholder management, it is imperative to illuminate the understanding of the concept of *maslahah* in Islam. According to Imam al-Ghazzali in his famous book *al-Mustasfa*, *maslahah* is defined as “an expression for seeking benefit (*manfaah*) or removing something harmful (*mudarra*)”. He further explained that *maslahah* is essentially the preservation of the objectives of Shariah which consists of five things: preservation of religion, life, intellectual, posterity and

⁹ Metwally’s argument corresponds to the Qur’anic text which emphasises on mutual cooperation. Refer to (Qur’an, 4:29).

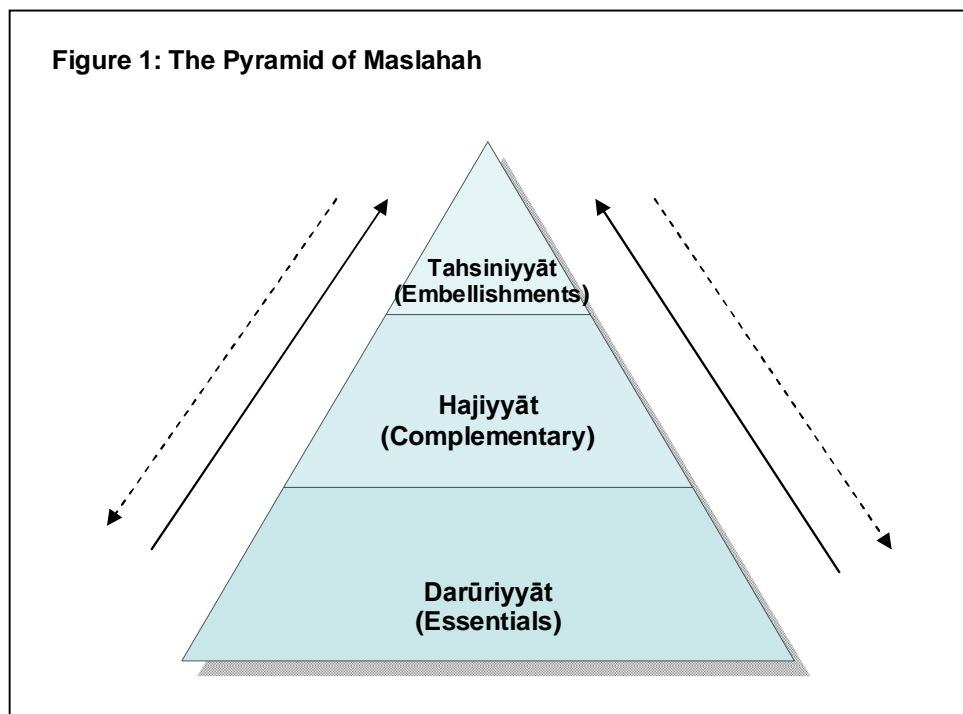
property. He concludes by saying: "What assures the preservation of these five principles is *maslahah* and whatever fails to preserve them is *mafsadah* and its removal is *maslahah*" (Al-Ghazali pp. 286-87).

Shatibi reinforces the definition given by Al-Ghazali. According to Shatibi, the primary objective of the Lawgiver is the *maslahah* of the people. The obligations in Shariah concern the protection of the objectives of Shariah which in turn aims to protect the *masalih* (plural for *maslahah*) of the people. Put it more simply, *maslahah* is taken to mean the protection of interests outlined by Shariah.

Shatibi classifies these interests into three categories, which he calls the essentials (*daruriyyat*), the complementary (*hajiyyat*) and the embellishments (*tahsiniyyat*). The essentials (*daruriyyat*) is necessary because they are indispensable in sustaining and preserving the five objectives of Shariah, in the sense that if they are disrupted the stability of the society will be at stake. The complementary *maslahah* are so called because they are needed in order to remove hardship and impediments and hence complement the essential interests. The disruption of *hajiyyat* is, however, not disruptive of the normal order of life. Finally, *tahsiniyyat* or the embellishments refer to interests whose realisation leads to refinement and perfection in the customs and conduct of people at all level of achievement.

On the whole, the principles of *maslahah* by implication reflect how Islam stresses the importance of taking into account public interests rather than merely individual interests. It provides a framework for decision making and a mechanism for adapting to change. Perhaps the principles of *maslahah* can further contribute in delineating the role of businesses in terms of CG. It offers guidelines for moral judgement on the part of managers and other stakeholders, particularly in solving conflicts that may arise when pursuing business activities.

To shed light on our discussion of the application of the principles of *maslahah* in stakeholder management, this study depicts the principles of *maslahah* in a pyramid form, illustrated in Figure 1.



The pyramid of *maslahah* as depicted in Figure 1 above functions as a framework and general guideline to an ethical filter mechanism by providing three levels of judgements to be used by managers to resolve ethical conflicts which inadvertently emerge while engaging in various business initiatives. The three levels also reflect the different degrees of importance in terms of fulfilment of responsibility. The bottom level, which is represented by the essentials (*darūriyyāt*), constitutes the most fundamental responsibility to be fulfilled as compared to the other two categories, namely the complementary (*hājjiyyāt*) and the embellishments (*tahsinīyyāt*).

Therefore, as the pyramid moves upwards, the degree of decision making will be less fundamental, albeit more virtuous, so as to attain the perfection and well-being of society. It assumes that individuals would strive for the next level as soon as the former is fulfilled. This presumption is grounded on the Islamic principles of motivation which encourages Muslims to continuously and consistently strive for excellence in order to gain the pleasure of Allah and better rewards from Him (Hasan 2002).

In essence, the performance of an organisation, according to Islamic ethical principles, is evaluated based upon the fulfilment of organisational objectives of continuous improvement and sharpening of the edge. The sense of continuous improvement will disappear if one cannot make today better than yesterday (Ahmad 2002). Hence, managers, shareholders and workers must not feel contented with the fulfilment of the essentials alone; instead, they must always strive for the betterment of the organisation since their personality and character have been shaped by the heightened sense of their ultimate accountability to Allah from which no one can escape (Al-Qaradawi 1998).

The three levels of the pyramid of *maslahah* are not mutually exclusive in the sense that all levels are inter-related and mutually dependent. This corresponds with the assertion made by Shatibi's who emphasised the inter-connectivity between the three categories of *maslahah*. The arrows pointing upwards and downwards along the pyramid of *maslahah* reveal the flexibility and mechanism of change in the decision making in the sense that any element which comprises one level of *maslahah* may be elevated upward or pushed downward depending on the different circumstances concerning the public at large. However, it should be noted that the flexibility posed by the principles of *maslahah* is confined within the framework of Sharī'ah but not vice versa (Mumisa 2002).

This reflects the dynamism of the pyramid of *maslahah* in assisting decision making processes within different contexts, time and space. If, for instance the circumstances change, inviting corporations to respond and consequently reconsider their roles within society, this will necessitate them to re-align all their business institutions (such as mission, vision, policy deployment, decision-making, reporting, corporate affairs, etc.) to the new *maslahah* so long as it does not contradict the principles outlined by the Sharī'ah. To further enlighten our argument on the pyramid of *maslahah*, particularly on how it can be applied to business endeavours, we shall analyse the different levels of decision making processes based on each principle of *maslahah*.

At the first level, within the scope of the essentials, managers are expected to strive for the preservation and protection of the essential needs (religion, life, intellect, posterity and property) of their stakeholders and public interests in general. For example, managers must protect the welfare or basic needs of their employees such as providing adequate prayer rooms and protecting the employees' safety and health in the workplace, thus reflecting the safeguarding of the faith and values of life respectively. Moreover, the managers must always confine their business operations to those that safeguard the values of religion, life, intellect, posterity and property. Accordingly, corporations have a moral and social responsibility to avoid any business activities, although they may be higher profits, which may cause disruption and chaos to the society's lives. The examples include business activities which can endanger the lives and disruption of people's intellect as a result of environmental degradation, and the manufacturing of illicit drugs for public consumption.

As soon as the scope within the essentials has been fulfilled, the corporations may strive for the second level, the complementary (*hājjiyyāt*) which is deemed beneficial to remove difficulties, even though it may not pose a threat to the very survival of normal order (Kamali 1999). For example managers who have fulfilled their essentials level may want to further extend their social responsibility commitment. In this

instance, the essential needs of employees such as fair pay and a safe workplace can be further extended to include continuous training and enhancing human quality programmes. The latter is not really essential in the sense that if managers neglect this kind of commitment, it will not pose a severe destruction to the employees. However, if the managers assume such a responsibility it is a fulfilment of the complementary interest that will advance the intellectual well-being (knowledge and skills) of the workers.

In some cases, such effort can sometimes be considered as the essentials (*maslahah darūriyyāt*). For example, Islamic banking institutions need to provide adequate Sharī'ah training to their employees concerning the Islamic financial instruments offered, so as to protect the interest of faith. Other examples of responsibility that may be regarded as part of the complementary interest include refraining from being involved in: the trading with or manufacturing or selling of tobacco and alcohol so as to prevent its consumption which affects the health of the public; the trading with, or manufacturing or selling of pornographic magazines and videos which may promote indecent behaviour of the public.

The highest level in the pyramid of *maslahah* is the principle of embellishments (*tahsiniyyāt*). Within the ambit of the embellishments, the corporations are expected to discharge their social responsibilities by engaging in activities or programmes that may lead to improvements and attainments of perfections of public life conditions. Involving in charity or giving donations to the poor and needy; providing scholarships to the less fortunate students and providing sufficient, correct and clear information or advertisement regarding products offered to customers are some of the examples of commitment with respect to achieving the embellishments for society.

On the whole, the pyramid of *maslahah* implies the need for corporations to engage and manage their business activities according to priorities. These priorities evolved from a deep understanding of the objectives of Sharī'ah such that preservation of interests (*maslahah*) is dealt in accordance to the different levels of importance and severity of consequences. For example, one must not focus on attaining embellishments while jeopardising the essentials. Similarly, one must not be obsessed with the attainment of benefits to the extent of creating harm or inflicting injury to others.

In the event of a conflict arising between the various interests of stakeholder groups, the principle of interests as reflected by the pyramid of *maslahah*, together with the Sharī'ah axioms such as the removal of hardship (*raf' al-haraj*) and prevention of harm (*daf' al-darar*) apply. These two principles are integral to the general concept of *maslahah*.

Drawing from these Islamic jurisprudence tools, Al-Qaradawi (1998, 2001) further explains that in the event of a conflict arising from various categories of interest, the lesser of these may be sacrificed in order to protect a higher interest; and an interest of a private nature is sacrificed for the sake of common interest while the owner of the private interest is to be compensated for his loss. Also, in cases of plurality of conflicting interests where none appears to be clearly preferable, then prevention of evil takes priority over the realisation of benefit. In the event of conflict between interests and harm, Al-Qaradawi asserts that the two have to be examined carefully in terms of their size, effect and duration. A slight evil or harm should be forgiven for the sake of realising a major interest or benefits. A temporary evil should be forgiven for the sake of realising a long-term or permanent interest. Even a great evil should be accepted if its elimination would lead to a greater evil. However in normal conditions, the avoidance of evil or prevention of harm should take precedence over the realisation of interest.

As a case in point, the natural conflict between profits maximisation and social responsibility doctrines may need to be carefully evaluated based on both principles of *maslahah* and harm prevention respectively. In the event that a company needs to retain profits for survival while reducing amounts of donations and contributions to the public, the prevention of harm and removal of hardship principles may be applied in this context, in the sense that retaining profits for survival is inevitable for sustainability and survivability of the corporation.

A similar framework may be applied in the case of physical health of a community at stake when a corporation decides to externalise its costs by emptying toxic wastes near residential sites. In this context

the prevention of harm principles prevail insofar as the rights of the community for their life protection should be protected, even at the expense of the shareholders' value, i.e. reduction in the profits of the company due to increase in costs. Another example is when the interest of the firm conflicts with that of the state, which represents the community as a whole; the firm must give in to the interest of the state. This is also one of the guiding principles of Shari'ah which decrees that private interests of a firm or individual should be secondary and subservient to that of the community as a whole.

Therefore, the pyramid of *maslahah* can contribute towards the establishment of guidelines for moral judgements or normative approach in stakeholder analyses and management. They also serve as viable models to devise principles for making trade-offs between the interests of shareholders, suppliers, employees, consumers, members of the general public, or anyone else who might qualify as a stakeholder. The framework also allows the managers to weigh and balance the interests at stake so that the normal operation of business can be run without causing harm or inflicting injury to any party.

CONCLUSION

This paper offers Islamic alternative views to the Western conceptualisation of stakeholder theory in the light of corporate governance issue. The Islamic worldview stands in stark contrast to many Western philosophical constructs of stakeholder value-based corporate governance since it grounds Muslim moral and ethical judgements to Islamic worldview and the principles of Shariah.

In particular, this study may benefit Islamic banking practitioners and Muslim entrepreneurs who need specific moral rules and principles in exercising greater corporate governance. The discussion on the pyramid of *maslahah* provides adequate ethical guidance to executives and entrepreneurs who must decide which courses to pursue and how much to commit to them. The framework of *maslahah* can assist them in managing ever emerging conflict of expectations of diverse stakeholders about corporate responsibilities more effectively and efficiently. Moreover, by understanding the principles of harm prevention embedded in the framework of *maslahah*, they in fact can make better choices when faced with situations that involve trade-offs.

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