

Mudarabah- A New Paradigm for Corporate Governance

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Abstract

It is increasingly believed that the shareholders have lost control over their wealth in the hands of management. As a consequent there is a need for an effective and efficient monitoring environment which can be materialized through active and effective participation of shareholders in policy making and major decision making. In this background, the purpose of this paper is to search for a new form of business organization in which the rights of all the stake holders are secured. "*Mudarabah*" is a basic mode of Islamic finance in which one party *rabb-ul-mal* (owner) provide capital to the *mudarib* (manager) to run business within a given paradigm. Here we are focusing on the point that how this concept can be applied in the context of corporate governance issues. Through applying this concept, much debating issue of activism of share holders can be addressed to a great extent. In addition the concept of limited liability can also be refined. As per teaching of Islam even the death of debtors can not write off the right of repayment of debt to the creditors. It may emerge into a new paradigm of corporate governance as the concept may leads to a major shift in principal-agent relationship. The concept can be successfully implemented either to structurally change the corporate form of business organization or make the way for a new form of business organization. However, there would be a need to form a global body to oversee and implement the recommendations. It will also require extensive legislation by the countries.

Keywords: Corporate Governance, *Mudarabah* Board, Paradigm

1- Introduction

"*Mudarabah*" is basically a mode of Islamic finance in which one party "*rabb-ul-mal*" (owner) provides capital to the "*mudarib*" (manager) to run business under a given mandate as per Islamic teachings. In the backdrop of corporate governance problems due to inherited characteristics of company form of organization, the relationship between "*rabb-ul-mal*" (owner) and "*mudarib*" (manager) can be used for a new paradigm for corporate governance. The application of the concept can help us to either revamp the company from of organization or invent altogether a new form of business organization.

Some important issues from an Islamic perspective related to company form of organization and corporate governance were discussed earlier (Amer, 2007). This paper is extension of it in the sense to look into the remedies in the context. As we know that a discussion is being going on among the Muslim scholars that whether the concept of company having features like limited liability and Judicial person is Islamic or un Islamic. For example famous religious Muslim scholar Mufti Taqi Usmani has found analogy between Islamic institutions/concepts of "*Waqaf, Baitul Mal*", Joint Stock, Inheritance under debt and the limited Liability of the master of a slave in his book "An Introduction to Islamic Finance" (2000). On the basis of these arguments he clears Public Ltd. Company as Islamic. He states:

"The upshot of the foregoing discussion is that the concept of limited liability can be justified, from the *Shariah* viewpoint, in the public joint stock companies and those corporate bodies only who issue their shares to general public."

However, Mujlisul Ulama of South Africa has discussed against these analogies in their book "The Concept of Limited Liability- Untenable in The *Shariah*" The book has been ended on the following conclusion:

"In conclusion, we can safely claim that this concept of the western *kuffaar* is conspicuous example of chicanery and legal deception in the wake of which ensure massive fraud and denial of fulfillment of "*huqooq*" of creditors"

"I want to add here that it is not simply denial of *huqooq* (rights) of creditors only. It is denial of *huqooq* (rights) of all the stake holders especially of share holders. The limited liability gives a weapon in the hand of management which leads to the practice of earning management. This is the worst business example of fraud and denial of fulfillment of "*huqooq*" (rights) of share holders. However, in view of the fact that the company is being used for all types of exploitation and snatching the rights of all the stake holders it is also involved in oppression (*Zulm*). This is also to be debated at length(Amer, 2007).

The final remarks of Mufti Taqi Usmani (2000), while discussing and clearing the concept of liability as Islamic, are worth while to be noted. He states:

"At the end, we should again recall what has been pointed out at the outset. The issue of limited liability, being a modern issue which requires a collective effort to find out it solution in the light of *Shahi'ah*,

the above discussion should not be deemed to be a final verdict on the subject. This is only the outcome of an initial thinking which always remains subject to further study and research.”

Today at a time of economic and financial crises, it is high time that we revamped present business and management theories and principles in lines with Islamic principles and so mend our severed relationship with Allah. This will also help to avert situations of economic and financial crises. The Qur’an and *Sunnah* could certainly help us to explore these opportunities. In this respect there are three immediate tasks that need to be taken in hand. These are:

- 1- Development of a New Financial System which create real economies instead of bubble economies through Islamic concept of creation of value to avoid economic and financial crises.
- 2- A New form of Business Organization replacing the present corporate form of organization to resolve governance issues which normally arise due to limited liability and separation of management from the ownership.
- 3- Development of a new accounting theory based on Islamic principles.

These are three urgent and important tasks which need to be addressed. Our aim should be to develop different disciplines which could ultimately replace present theories and practices in the exploitation-oriented business world so that non-Muslims may also benefit (Author, 2009).

Earlier some work has been done on development of a new accounting theory based on Islamic principles (Amer 2007, 2008, 2009, 2012 and 2013). Here we are trying to explore the idea of a new form of business organization based on Islamic concept of “*Mudarabah*”.

2- Literature Review

“Companies have been around for a few centuries, the earliest of which existed around the sixteenth century in England and Holland. Originally a corporation (as they were known at the time) was a social invention of the state. That is, a state grants a corporate charter, permitting private financial resources being used for public purposes. This initial creation of private finance and merchants was to aid in the colonial expansion of Britain and served to expand colonial and imperial interests to start with, as well as help in war efforts between empires” (khilafah, 2007). The worst form of this is East India Company and the people of the Indo Pakistan sub continent still have the bad taste of their slavery at the hand of British Empire due to it.

A company can be defined as an artificial person created under the law of a country. The distinct features of companies are separation of management from ownership and limited liability. These are two tools in the hand of management which leads to the snatching of rights of other stake stakeholders. Consequently a scenario has been built where ultimately the society is being suffered in the shape of financial & economic crises, shortage of food and water and poverty in the major population of the world. Although in the opinion of the author the main cause of this situation is present financial system based on interest but the company form of organization can be considered itself an extension of the same.

It is true to say that the shareholders have lost control over their own wealth and the officers have gained control of the wealth which they do not personally own. A book by title “In Defense of the Corporation” has been written by Robert Hessen in response to Ralph Nader (a US legislature) attack on Corporations. While criticizing Nader, the writer says:

“Nader maintains that shareholders are inactive because they have been denied access to information about corporate activities. But there is another explanation for their inactivity; it is a deliberate decision for most shareholders. They are attracted to corporate shares precisely because they will not be required to participate in managerial decision making. What they seek is a sideline investment, an opportunity to entrust some of their savings to managerial specialists in return for share of the resulting profit.

Critics frequently denounce the separation of ownership and control in giant corporations; yet it merely represents avoiding specialization of function or division of labor.”

In my opinion the critics are not denouncing separation and control to avoid specialization of function or division of labour but actually they are against the exploitation being done by the professional managers of companies (Amer, 2007). Even if we considered the feature of separation of management from ownership parallel to the concept of “*Mudarib*” (Manager) and *Rabb-ul-Mal* (Investor), the losses to owners by the fraudulent act or negligence of managers can not be justified. However, in *Mudarabah* the *Rabb-ul-Mal* (Investor) has not only the right to give a determined domain to the “*Mudarib*” (Manager) for functioning but also has the right to involve him (*Rabb-ul-Mal*) in major policy decision making.

So on the analogy of relationship between “*Mudarib*” and “*Rabb-ul-Mal*”, the share holders must have an effective role in the management of the company. The list may include hiring and firing of key officers and fixation their remuneration, approval of all type of major contracts, major investment decisions and of course adopting accounting policies and procedures etc. Unfortunately we have created an artificial person and through giving it a legal cover have made it superior to a creature of Allah Subhanu Watala who is called “*Ashrafull-Makhlūqat*” (Most Superior Creature). Even in west the opposition to this so called artificial person is increasing

day by day.

The modern world is built on two centuries of industrialization. Much of that was built by equity finance, which is built on limited liability (Economist December 1999). The concept of limited liability was introduced two hundred years ago in order to enable the large scale investment necessary for the Industrial Revolution to take place (Crowther, March 2006).

From this short exposition it can be seen there are some fundamental differences between companies in Islam and those in the West, the structure of the corporation in the West fundamentally disagrees with the Islamic rules of company structures, this would make the purchase of shares in them invalid as well as the shares represents a piece of the company and the company is invalid from Islam (Khilafah (2007). He has come to defined Islamic companies

I. **The Company of Equals (Al-'Inan)** this is where both partners put their money into a business and work with it. Both partners would have the right to buy and sell and take the company forward, hence all partners are all equal in their deposit.

II. **The Company of Bodies (Al-'Abdan)** this is where two or more people come together with their skills such as a consultant, doctor or craftsmen. Although they use their money, the skill they have is what constitutes the basis of the company.

III. **The Company of Body and Capital (Mudharaba)** this is where one funds the capital of the business and the other partner works with it. The partner who provides the capital element is a silent partner and takes no part in the running of the business. The other partner buys and sells on behalf of the company.

4. **The Company of Reputation (Wujooh)** this is a company similar to madharabah but the capital is provided by a silent partner who has respect and standing and based upon this the company trades. The partner could be a rich merchant, which would mean debts will always be paid by this company as they are backed by a wealthy individual.

5. **Company of Negotiation (Mufawadha)** this is any combination of the above.

Imran Ahsan Khan (1998) discussed a new model of company by the name of "The Islamic Corporation: A New Model". This model is based upon the concept of "wakalah" and some features are based on the "inan partnership". Again it may be subject to wide criticism as it requires huge debate and *Ijtihad* among the Muslim scholars. Unfortunately it has the same features of limited liability and there is no surety that it can check the exploitation and ensure rights of all the stock holders.

However, like as in other areas of business, Muslims scholars as a whole has been failed to come forward and invent a new form of business organization which can counter the exploitation being made by company form of organization. Kuran (2006) explored that why Islamic law did not develop a concept akin to the corporation, or borrow one from another legal system. While discussing different reasons he states:

"In the course of a millennium when western charities, religious bodies, universities, and cities adopted the corporate form of organization, in the Middle East analogous functions came to be served primarily by the waqf, the Islamic analogue of the trust. Like a corporation, a waqf could outlive its founder. But it was not considered self-governing. Required to follow the founder's directives, its mutawalli lacked the discretion necessary for maximizing profitability of the corpus. If such discretion did not emerge over time, and *waqfs* failed to become self-governing and profit-maximizing organizations, a basic reason is that vested interests stood in the way".

Mudarabah has rich roots in Islamic history. Muhammad (Sallallahu 'alaihi wa Sallam) himself was a *Mudarib*. The Sahaba (RA) also practiced it. 'Umar b. al-Khattab (RA), 'Uthman b. 'Affan (RA), 'Abd Allah b. Mas'ud (RA) and 'Ali b. Abl Talib (RA) are a few examples (Hassan, 2010). The practice of Mudarabah was also continued after the era of Sahaba (RA). Hassan (2010) has quoted some examples of such contracts in his article. Then there is very good example of Imam Bukhari who was himself a *rabul- ul- mal* (Dawood, 2004). The importance of Islamic finance in the modern world can be judged from the fact that concept of venture capital is based on its concept of "Mudarabah". We are well aware that one of the main causes of USA industrial development is venture capital. However, unfortunately so far the Muslim world has almost ignored it.

The study of relationship between *mudarib* and "rabb-ul-mal" can lead us to develop a new form of business organization, replacing present company form of organization. In the direction first we have to see quickly the major features of management under "Mudarabah".

3- Major Features of Management Under "Mudarabah"

- 1- Agreement of Owner for Investment in Specified Venture/ Business.
- 2- Debt can not be taken without consent of Investor.
- 3- Under Mudarabah the loss is to be borne by Rab-ul-Mal but in case of negligence or dishonesty the loss is to borne by "Mudarib".
- 4- The assets are owned by the "Rab-ul-Mal" and profit is shared according to the agreed ratios among the parties.

- 5- "*Mudarib*" and "*Rab-ul- Mal*" can be several.
- 6- Termination of *Mudarabah* by either party through giving a prior notice.

4- Sketch of a New form of a Business Organization

Keeping in view the features of *Mudarabah*, a sketch of a new form of business is discussed below:

5.1 Constitution of a Board of *Mudarabah*

The managers/investors who are interested to manage a particular business would have to constitute a board which would be called "Board of *Mudaribs*". The board would have the power to run the business as per given mandate under contract of "*Mudarabah*" as stipulated in "*Shariah*". In case of loss due to negligence or fraud of *mudarib*, the loss would be made good to the owners by him self.

5.2 Determination of Mode of Scope of Business by the Investor.

The owners would have the power to specify the board to do particular business as per spirit of "*mudarabah*". The "*rab-u-l mal*" would also define the scope of business and major policy directions in this respect.

5.3 Liability of Loan/Credit would be rest with *Mudarib*

The liabilities for loan/credit taken by *Mudarib* without permission of investor would be rest with him (*Mudarib*). In order words the approval of investor for taking loans and credits would be mandatory on *rabul mal*.

5.4 Agreed Ratio of Profit for *Mudarib* as Compensation

The members of Board of "*Mudarib*" would be entitled to get the agreed ratio in actual profit as mutually agreed between "*mudarib*" and "*rab-ul- mal*".

5.5 Formation of *Mudarabah* form of Organization

Such type of business organization can be formed either by *rabul mal* or "*mudarib*".

5.6- Transfer of Ownership

The ownership can be charged through a proper contract in the light of famous *Hadith*. "All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful" (Usmani, 2000). This can solve the problem of liquidation.

5.7-Size of Capital

The "*rab-ul-mal*" can be large in numbers and size of capital can be determined through proper contract. The liability of powers would be as per set obligations as per spirit of "*Mudarabah*" concept of Islam.

5.8- Resolution of Differences in opinion in *Shariah* Scholars

The difference of opinion between different *Shariah* scholars can be resolved through a proper contract in the light of famous *Hadith* regarding mutual consent of parties as quoted above. Further every organization should have the legal right to work as per the faith of its *mudarib* and "*rab-ul- mal*".

6- Legal Frame Work

A strong legal framework with in the parameters of *Shariah* would be required to regulate and monitor such type of organization. This will include matters like formation, constitution of board of *mudarib*, raising capital, maintaining books of accounts, accounting policies, auditing, financial reporting, arbitration and termination etc. In this respect one of the important tasks would be to formulate new accounting standards based on Islamic teaching so that value of transaction could be done in most fair manner.

7- Modus Operandi for Facilitating the Proposed Form of Business Organization

Here we have discussed the basic idea to use the concept of *Mudarabah* for inventing a new form of business organization in view of governance problems mainly due to limited liability and separation of management from the ownership features of company form of organization. Most importantly these two inherited ingredients are un-Islamic but Muslim word so far failed to present an alternate to company form of organization despite of exploitation of Muslim financial resources and population in the hands of companies. Further the theory and practice of *mudarabah* would had been used for not only evolving a new financial system but it would had been used for forming a new form of business organization. But so far no commendable efforts have been done in this respect specially for inventing a new form of business organization. As the work is to be started from scratches a lot of efforts are required to make it a reality. Due to this fact and its wide scope it is proposed that a first step a task force, representing *Shariah* scholars, accounting & finance professionals, legal experts, entrepreneurs and representative of government of all members' states may be constituted by OIC. The immediate task of this task force would be to do the ground work and give its recommendations. The task force may arrange a series of conferences for brain storming.

Upon completion of assigned task successfully by the task force and approval at OIC level, a 2nd task force may be constituted by the organization to facilitate the work for implementation. The scope of 2nd task force would also include to do home work for establishing a central institution for the whole Muslim world to oversee the whole system under the umbrella of OIC. The new institution will not only be responsible for giving practical

shape to the proposed new form of business organization but would also be responsible for its enforcement through branch offices in all over the Muslim countries and non-Muslim countries who opt to embrace it, in-sha-Allah.

This institution will also be responsible for regulating and monitoring the new form of business organization in the Muslim countries in the first stage with the help of regulatory bodies in the respective countries. However, ultimately the responsibility to regulate and monitor such organization would be solely shifted to the concerned countries.

8- Conclusion

There is a need that we altogether overhaul the company form of business organization through revamping completely the concept of separation of management from ownership and limited liability. This will not only help to resolve the governance problems but also check the empire image of companies that it is involved in silent take over of word. (In my opinion they have already taken over the world as even the government of only super power is help less in front of them). In this context the teachings of Islam on “*Mudarabah*” can bring a revolution both for developing a new financial system and evolving a new form of business organization.

The idea to invent a new form of business organization on the concept of “*Mudarabah*” discussed here is of very preliminary stage. So there is a need that these points are deliberated among Shariah and business experts in detail. But it is high time to take forward the relationship of *mudarib* and *rab- bul- mal* for giving it a shape of business organization which would have the features of discarding limited liability concept and engaging highly professional managers but side by side the owners should have full control over their assets.

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