AGENCY THEORY, STEWARDSHIP THEORY AND STAKEHOLDER THEORY: AN ISLAMIC PERSPECTIVE

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ABSTRACT

Recent events have placed an emphasis on the need for effective corporate governance. Corporate scandals leading to the downfall of financial giants such as Enron and WorldCom in 2003 and the global financial crisis of 2008-2009 have revealed serious inadequacies in the quality of corporate governance at an international level. Existing standards are lack in providing the necessary guidelines for checks and balances that corporations need to cultivate sound business practices. There are various conventional theories, namely the agency theory, stewardship theory and stakeholder theory articulated throughout time in determining the most effective system of corporate governance. Many developed and developing countries as well as organizations have laid down the Best Practices for Corporate Governance based on the prevailing corporate governance theories. To the extent of the researchers' knowledge, corporate governance problems become more serious day by day even at the existence of the tight rules and regulation of corporate governance. Therefore, these governance problems motivate the researchers to examine the foundation of the corporate governance guidelines, i.e. corporate governance theories from the unconventional and non-mainstream aspect. The objective of this paper is to examine agency theory, stewardship theory and stakeholder theory from an Islamic Perspective.

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Key words: Corporate governance, Agency Theory, Stewardship Theory, Stakeholder Theory, Islamic Perspective.

1.0 INTRODUCTION

Under the western notion, a corporate governance system consists of ‘a set of rules that define the relationships between shareholders, managers, creditors, government and other stakeholders (their respective rights and responsibilities)’ and ‘a set of mechanisms that help directly or indirectly to enforce these rules’. Corporate governance can also be defined as ‘the processes and structures to direct and manage the company towards enhancing business growth and realizing long-term shareholder value while taking into account the interests of other stakeholders’. Essentially, corporate governance provides a sound framework for the resolution of issues and conflicts between stakeholders of an organization (Khir, Gupta and Shanmugam, 2008).

These definitions and guidelines of corporate governance are normally derived from the prevailing corporate governance theories. Islamic financial institutions are required to comply with conventional corporate governance guidelines since they are operating the dual banking system. Thus, it is essential to look at these theories whether they are in line with Shari’ah values or not. The purpose of this paper is to focus on it. Moreover, it is also proposed Islamic corporate governance system derived from tawhid and shura-based approach and the stakeholder focus.

The closest concept to ‘governance’ in Arabic is al-hakimiya. Its meaning extends beyond the technical view and includes the process of identifying a “higher moral social order” to which all decision-making ought to be founded. (Bahlul, 2000).

This paper is organized in five sections. Section 2 is a detailed discussion on 3 major corporate governance theories in a conventional setting, namely the agency theory, stakeholder theory and stewardship theory. Section 3 explains what corporate governance means from Shari’ah perspective. Upon appreciating what it means in Islam and the concepts involved, we will provide a comprehensive evaluation of the 3 theories from an Islamic point of view in Section 4. Finally, Section 5 provides a review of the 2 models for an Islamic corporate governance framework designed by Muslim scholars – the Tawhid and Shura-based approach as well as the Stakeholder approach.

2.0 CONVENTIONAL CORPORATE GOVERNANCE THEORIES

The theories or models of corporate governance have evolved throughout the years. It began with the agency theory, expanded into stewardship theory and stakeholder theory. The following sections describe each of these theories in detail.

2.1 Agency theory

Agency theory is referred as the principal-agent model. It highlights the relationship between agents and principals based on contracts (Jensen and Meckling 1976). This concept focuses on the agency cost due to the separation of ownership and control (Jensen and Meckling 1976). In the context of a firm or company, such relationship is between the managers and the shareholders. The underlying assumption in agency theory is that, due to human nature, each individual has its own desire and makes effort as much as possible to maximize the benefits (Chua and Chrisman, 2006). Hence, this theory mentions that both agents and principals have their own personal agendas which might contradict each other. Initially principals delegate powers to agents so that agents are expected to work in the best interest of principals. Unfortunately, this might not the case (Jensen and Meckling 1976). As a result it leads to divergence or conflict of interests between the agents and principals and this conflict is the main problem explained by the agency theory (Shapiro 2005). In the context of a company managers set their own personal goals whereas the shareholders want to maximize their wealth as well as enhancing the performance and sustainability of the organization in long term (Shapiro 2005; K Ramachandran and Jha 2007).

Second problem that can be found in agency theory is due to the asymmetric information. Agents know more information on how to run and manage the company compared to the shareholders. Moral hazard problems can also occur as they may abuse the power given and act opportunistically for their own benefits at the expense of the shareholders. Moreover, adverse selection can also happen as the principals enter into contract with the agents who have misrepresented their abilities (Cribb 2006). The cost of monitoring the behavior and actions of the managers is commonly known as agency cost. In other words, agency cost refers to cost incurred by the shareholders in order to ensure that the agents are working optimally for the best interest of the shareholders.

2.2 Stewardship theory

The concept of stewardship originates from both the Old and New Testaments (Crib 2006). Stewards are considered servants running households committed in their works to serve their masters. Stewardship theory embodies the concept of altruism. Altruism, literally, refers to a selfless concern for the welfare of others (K Ramachandran and Jha 2007). In the organizational context, this means being considerate and tolerant towards one another's needs, thereby fostering a sense of loyalty and commitment to the firm as well as to each other (K Ramachandran and Jha 2007).

Unlike agency, the stewardship theory considers the trust based relationship. Stewards can be seen as less individualistic less opportunistic, pro-organizational and collective behavior (Robins, 2008). They work for the best interest of the firm and maximize the wealth of shareholders. They can attain the true goal of the organization emanating the convergence of interest between the stewards and shareholders (Corbetta and Salvato 2004).

They are motivated by intrinsic reward such as achievement and recognition and it cannot be quantified (Corbetta and Salvato 2004). Stewards believe that by fulfilling the needs of the organization, their personal needs can also be satisfied. Less controlling mechanisms and organizational structures are needed according to this theory (Crib 2006). Autonomy is given to the stewards so that they can work independently and maximize the benefits of shareholders. Stewardship theory suggests the role of the CEO and the chairman to be unified hence agency costs can be reduced and greater role of stewards can be realized (Haslinda and Valentine 2009). Empirical study has also proven that stewardship theory is best suited with family-orientated businesses (K Ramachandran and Jha 2007).

2.3 Stakeholder theory

Freeman (1984) defines stakeholder theory as "any group or individual who can affect or is affected by the achievement of the organization's objectives". This theory is also known as European model and widely practiced by the European countries like Greece and France. Generally, stakeholders refer to people who have interest and stake in an organization. They contribute skills, knowledge and expertise towards the organization. According to Freeman

(1984), the stakeholders refer to "groups of constituent who have legitimate claim on the corporation or a person who contributes directly or indirectly to the firm" (Zulkifli Hasan, 2009). The stakeholders are divided into two types: inside stakeholders and outside stakeholders. The inside stakeholders are those who involve directly in the company as managers, shareholders or the workforce. Meanwhile, the outside stakeholders are people who do not own the company but have some interest in it. Customers, suppliers, communities and government as well as political groups are known as outside stakeholders.

All these group of people take part in an organization or business to gain benefits. Clarkson (1995) asserted that "the firm is a system where there are stakeholders and the purpose of the organization is to create wealth for its stakeholders" (Haslinda and Valentine, 2009). Unlike the agency theory, the firm's objective in the stakeholder theory is to maximize interest of all stakeholders instead of shareholders only. This means, from the firm point of view, the director's role and responsibility extends to not only its investors, but also emphasizes the maximization of the interest of broader parties as well. In other words, this theory is concerning on business morality as well as profit maximizing.

In addition, the stakeholder theory rejects the three main principles in the shareholder model of corporate governance and it argues that: (1) all stakeholders have a right to participate in corporate decisions that affect them, (2) managers have a fiduciary duty to serve the interest of all stakeholders groups and (3) the objective of the firm ought to be the promotion of all interests and not only those of shareholders (Iqbal and Mirakhor, 2004).

However, there is a problem arise from this theory. As mentioned above, the stakeholder theory is very concern about its stakeholders' interest and welfare. However, the supporters of agency theory are criticizing the stakeholder theory, whereby they argue that it is impossible to fulfill and consider the interest of the stakeholders. This is due to a various number of the stakeholders and how the stakeholder theory is going to balance the demands among a range of the stakeholders.

3.0 CRITICAL ANALYSIS OF THEORIES

Based on the above discussion, the conventional corporate governance theories are not entirely flawless since they have been developed based on human beings and our applied logic.

Moreover, no one theory is able to provide a consolidated approach applicable to any circumstances. This can be attributed to human weakness because of our limited capacity to understand all and see beyond this world. The main objectives behind the formulation of these theories are to gain worldly benefits and take care of the shareholders through profit maximization. Therefore, we can safely surmise that the conventional theories of corporate governance, even if they may be in line with Shari'ah, cannot be regarded as an "eternal reference" in solving all aspects of current corporate governance issues.

Existing theories merely focus on the physical aspect of corporate governance such as the leadership structure and composition of the board. Majority of suggested practices are consistent with decision-making based on the shareholders' perspective. Existing theories do not emphasize on the spiritual aspect that could potentially have a substantial influence on the effectiveness of corporate governance.

3.1 Agency theory from the Islamic perceptive

Banks are generally less transparent than other financial institutions and this intensifies the agency problem. As far as the agency theory is concerned numerous ethical issues arise which are not in conformity with Islamic teachings. Firstly, this theory propounds that principals delegate powers to the agents to manage the company and from the Islamic point of view this is considered as a trust (amanah). Therefore, the agents must strive and put their best effort in fulfilling their contractual duties and responsibilities. Nevertheless, in reality, agents tend to ignore the importance of responsibility and accountability, as they are opportunistic and self-interest individuals. *Allah (Holy Quran, 2:284) has warned us that we will be held accountable in the Hereafter for every single action. Whether you show what is within yourselves or conceal it, Allah will bring you to account for it. Then He will forgive whom He wills and punish whom He wills, and Allah is over all things competent.*

Secondly, it is to be noted that in agency theory the agents hold certain information concerning to the management of the company which can be vital in decision making process and the principals in most cases are not aware of such information. Indeed, it is the duty of the agents to disclose any important information to the principals and to be transparent in doing their jobs. Unfortunately, in some cases they fail to do so and this clearly violates the Islamic values in relation to the principle of transparency which has been highlighted in the Holy Quran, 5:119; Allah will say, *"This is the Day when the truthful will benefit from their truthfulness"*

Thirdly, moral hazard problem caused by the agents is a sufficient indicator. It is because the agents are unjust to the principals due to the fact that agents have breached the trust given to them. In Islam, the principle of justice has always been the key point to ethical values and this can be seen in the Holy Quran, 5:8; *O you who have believed, be persistently standing firm for Allah, witnesses in justice, and do not let the hatred of a people prevent you from being just. Be just; that is nearer to righteousness*.

Lastly, the issue is related to the adverse selection. This problem occurs when the principals have limited knowledge and information prior to the creation of the contract. In Islam we are reminded to tell the truth and speak nothing but the truth. This principle has been enunciated in the Holy Quran, 33:70;. *O you, who have believed, fear Allah and speak words of appropriate justice.*

In conclusion, we are of the view that agency theory transgresses the principles of Islamic corporate governance.

3.2 Stewardship theory from the Islamic perceptive

In our present scenario, stewardship theory embodies two main principles of good corporate governance, namely responsibility and accountability. Stewards dedicate their works for the sake of others and understand the responsibilities vested upon them. They are also aware of the fact that their actions can be questioned and accounted by the shareholders. These principles have always been underlined by Islam and stipulated in the Holy Quran, 4:58 and 8:27 respectively; Indeed, Allah commands you to render trusts to whom they are due and when you judge between people to judge with justice.

O you who believe! Betray not Allah and is Messenger, nor betray knowingly you Amanah (things entrusted to you, and all the duties which Allah has ordained for you.

However it comes to our knowledge that the objective or the aim in life upheld by stewardship theory is totally different with the main objectives of Islamic corporate governance. Stewardship theory contrastingly adopts the shareholder-centered model whereby stewards serve for the best interest of the shareholders only. This model is obviously contradictory with Islam because the main objectives of Islamic corporate governance are to seek pleasure from Allah and to achieve falah (eternal happiness) in the Hereafter. In Islamic point of view, corporate governance should be based on a stakeholder-centered model in which the governance style and structures protect the interest and rights of all stakeholders rather than the shareholders only (Iqbal and Mirakhor, 2004).

3.3 Stakeholder theory from the Islamic perceptiv*e*

Unlike the agency theory, the stakeholder theory closely resembles Islamic teaching on corporate governance. The main reason is it emphasis on property rights and contractual framework. Nevertheless, Islam provides a more solid and clear justification regarding these two concepts.

'Property rights' in Islam refers to the stakeholders' right to involve and participate in decision-making as well as their responsibilities and accountability towards the firm or business. In order to hold the right of property, we must first identify who qualifies as a stakeholder. From an Islamic point of view, stakeholders are those whose property rights are at risk or at stake due to voluntary or involuntary actions of the business (Iqbal and Molyneux, 2005). It shows that the firm is obliged to preserve the property rights of all individuals who are taking part in the business activities, not limited to capital providers or shareholders.

With regards to property ownership, Islam views that Allah is the sole owner of any property and human beings are only trustees or custodians. Hence, mankind has an obligation to manage and use the property in accordance to Shari'ah principles. This is clearly stated in the Holy Quran, 57:7; *Believe in Allah and His Messenger, and spend of that whereof He hath made you trustees.*

In Islamic corporate governance, the right of property is based on the three principles of property law in Islam. The first principle emphasizes on the concept of collectivity – should individuals or firms acquire a particular property, it should be shared with others in the community, society and state as they also have rights on that property. Secondly, the property of others cannot be harmed or violated. Thirdly, Islam considers rights as property (al-mal). Therefore, any property acquired through unlawful means automatically loses its legitimacy and the acquirer has no right to said property. Thus, it is compulsory to ensure that source of the property is based on Shari'ah (Maria and Ishaq, 2009: 79).

In terms of contractual framework, it means that everyone who is involved in any business has a duty to perform. He has to meet his contractual obligations as stipulated in the contract whether directly or indirectly and is subjected to the Shari'ah rules and principles (Zulkifli Hasan, 2009). To reiterate, those who with implicit or explicit obligations towards the firm are all considered as stakeholders. Islam is very concerned in fulfilling the contractual obligations as stated in the Holy Quran, 5:1; *O you who have believed, fulfill (all) contracts.*

This is important and encouraged in Islam because it demonstrates justice and prevents betrayal. One's contractual obligation is a trust and breaching one's trust is likened to treachery that is prohibited in Islam. As discussed before, the conventional stakeholder theory is concerned with stakeholders' rights and interest. This is similar with the Islamic corporate governance theory on stakeholder model. Islamic corporate governance also stresses on the importance of maximizing the welfare of all stakeholders through the property rights and contractual obligation principles.

Proponents of the agency theory criticize the stakeholder theory as it potentially brings about conflict of interests when concerns of all stakeholders have to be taken into account. This is mitigated in Islam as the religion provides remedies based on the principle of *maslahah* (public interest). Therefore, it shows that the stakeholder theory in corporate governance is in line with Shari'ah.

4.0 ISLAMIC CORPORATE GOVERNANCE SYSTEM

Effective corporate governance is especially crucial in businesses that operate within an Islamic framework so that interests of stakeholders remain protected. More importantly, interests of stakeholders in the Islamic context go "beyond the financial return or profit maximization" (Zulkifli Hasan, 2011). It includes ethics, Islamic law and the principle of *tawhid* or oneness of God. Hence, Muslim scholars have created two models that reflect such values since the conventional theories are generally not in line with *Shari'ah*.

4.1 Shari'ah Advisory Council

Before a discussion on both models, there is a need to distinguish the corporate governance structure Islamic organizations (bank) operate under, as compared to their conventional counterpart. There are (a) an Islamic organization must serve God and (b) the organization should not participate in prohibited activities. With regards to Islamic banks, financial activities should be free from interest and based on Islamic legal concepts such as Mudarabah and Musharakah.

Besides having a board of directors, every Islamic bank is required to appoint a board of Islamic scholars and establish a Shari'ah Advisory Council (SAC). Such a set-up is critical to achieve public confidence. According to Zeti (2002), the SAC serves as a "check and balance to ensure both the management and operations of Islamic banks do not deviate from Islamic principles".

As Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic financial services Board (IFSB) and Bank Negara Malaysia (BNM) have formulated guidelines to reinforce the authority of SAC by clearly defining roles and responsibilities of the scholars and thorough decision-making processes.

4.2 Islamic Corporate Governance Models

There are two models in building an Islamic corporate governance system namely the Tawhid and Shura-based approach and the Stakeholder approach.

4.3 Tawhid and Shura-Based Approach

The first model is known as Tawhid and Shura-based approach. It is founded on the oneness of Allah – the central theme of Islamic economics. This approach rejects the conventional model where its epistemological aspect is based on the rationalism and rationality.

The concept of tawhid reveals that Allah creates human being as a vicegerent and He monitors and aware every single thing happens all the times. In Islamic corporate governance, the stakeholders are known as vicegerent of Allah. They are responsible to perform the duty to uphold the principle of distributive justice through shura (consultation) (Zulkifli Hasan, 2009).

According to Chapra (1992), the practice of shura is vital and it is part of the obligations that should be adopted by the firm and organization. The stakeholders can participate in the corporation by the shura approach.

Under this model, there are two institutions involved, namely Shari'ah board and the constituent of shura's groups of participants, which monitor and govern all the activities of the firm so that its operation is in line with shari'ah principles. In term of decision-making process and policy framework, the shareholders are considered as active participants and conscious stakeholders. They should also consider and protect the other stakeholders' interest and rights instead of focusing on the profit maximization alone. Other stakeholders also have rights to protect the interest as a whole and enhance social wellbeing function for social welfare (Zulkifli Hasan, 2009).

4.4 Stakeholders Based Approach

The second model is the stakeholder approach and it aims to protect the right of all stakeholders, based on the principle of property rights as well as contractual framework. According to Islamic law, the main role of the principle of property rights is to ensure that the interest and rights of every stakeholder such as individual, community and state are protected. The property is not only in term of real goods, but everything that is useful and has value is also considered as property. Everything in this world is created by Allah and belongs to Him. As human beings are mere trustees towards the property, it is our duty to ensure that the property is used and well-managed in accordance to shari'ah law. This principle also recognizes private and society or state in corporation (Zulkifli Hasan, 2009: 286). In the corporation, the individual ownership is recognized as shareholders and the existence of shari'ah rules guides every level of people involved in the business on how to deal with the property ownership.

Islam is very concerned about individual obligation. Therefore, the contractual framework becomes the foundation in this Islamic model of corporate governance. In corporate governance, the contract bound stipulates the rights and obligations of the individual towards the corporation or business. Those who have direct or indirect contract in an organization are known as stakeholder. Hence, the stakeholder is accountable to perform his or her obligation as stated in the contract. Zulkifli Hasan (2009) mentioned that Islamic principle of contract provides guidelines to determine and define who is a rightful stakeholder. Iqbal and Mirakhor (2004) have formulated tests to identify who qualifies as a stakeholder by determining the explicit and implicit contractual obligations of individual or group and by identifying the individual property rights are at risk during the process of earning of the firm's property.

Unlike conventional theories of corporate governance, the stakeholder based approach makes Shari'ah board act as an advisor and supervisor, particularly in Shari'ah matter. The role of the Shari'ah board is to ensure all the operations and transactions of the firm are in line with Shari'ah law. In this model, all levels of people are interrelated each other and everybody has their own duty to serve. For example, the boards of directors, on behalf of the shareholders are responsible to monitor the business activities. Meanwhile, the manager's duty is to manage the firm and serve the stakeholders' interest, while the other stakeholders have duty to fulfill their contractual obligations (Zulkifli Hasan, 2009: 286).

5.0 CONCLUSION

Generally conventional theories of corporate governance are not in line with Shari'ah. The stakeholder theory seems to be the closest to what has been prescribed by the Islamic view of corporate governance but even it does not meet the main objective of seeking pleasure from Allah and achieving falah in the Hereafter. In addition, the welfare of the society must also be taken into consideration. Due to their preoccupation with shareholders' interests, organizations including banks have been criticized for being too concerned with profit maximization, at the expense of other stakeholders. Interestingly, Islamic financial institutions today, especially public-listed companies, continue to follow guidelines provided by respective regulatory bodies that are founded based on these theories. Even though the theories discussed are not in line with Shari'ah, they are the dominant and mainstream. Therefore, Islamic organizations have to comply with them in order to compete in the business world. This situation remains as such until the Islamic finance industry becomes a more dominant player of financial services in the world.

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