

The Roles of Corporate Governance Towards Value-Oriented Islamic Finance Practices

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Abstract

This paper argues that while significant concerns have been invoked on the material aspects of Islamic finance such as financial growth and products sophistication, it is nevertheless observed that equal emphasizes have not been given on social objectives of Islamic Financial Institutions (IFIs) as part of its value-oriented frameworks. In the absence of extensive discourse on corporate governance and its roles on corporate social responsibility (CSR), this paper attempts to highlight the importance of corporate governance in stimulating the social function of IFIs within the Islamic ethical dimension paradigm. This paper aims at expanding the normative objective function of IFIs by advocating CSR *via* strengthening the corporate governance framework. Unlike the western concept of corporate governance, which is based on the western business morality that derived from “secular humanist”, this paper suggests that corporate governance in IFIs is founded on the epistemological aspect of *Tawhid*, Shariah and ethics. This paper employs theoretical and case study research method to develop understanding and to advocate the notion of value oriented Islamic finance practices. The study utilizes descriptive, comparative and critical analysis approaches in extracting and analyzing the information.

Keywords: *Value-oriented, Islamic finance, CSR, Shariah.*

Introduction

One of the most important aspects that deserves due attention in Islamic finance is corporate governance and social responsibility. The emergence of CSR in business organization for the past three decades triggers the need of IFIs to be more socially responsible. In view of the moral failure, corporate collapse and lack of ethical values in business organization, CSR outlines the ideal standard of behavior of the firm from social oriented value perspective¹.

In line with the ideal aspiration of Islamic finance and Islamic economic, IFIs are expected to have two-fold objectives i.e., profit-oriented and social-oriented functions. In the context of corporate governance in Islam, IFIs are not only required to fulfill their economic functions but also to play significant roles in addressing the socio-economic issues

as part of their corporate responsibilities. This foundational dimension is based on the holistic approach of corporate governance whereby its framework is beyond the relationship between the shareholders, board of directors, management and stakeholders but to include as to how maintaining the relationship with the God. In this aspect, IFIs require additional framework of Shariah and ethical in character to safeguard and maintain not only the relationship with the God but to include correlation with the human being as well as the environment. As such, CSR can be the most appropriate platform and mechanism for IFIs to fulfill their social responsibilities as part of their religious obligation.

While acknowledging the solid and cogent theoretical foundation of CSR in Islam, the

reality indicates otherwise where there is lacking of initiative by IFIs to implement CSR as part of their corporate social objectives. Usmani, (2002: 113) vividly mentions that philosophy of Islamic finance is not only motivated by profit *per se* but more important to establish distributive justice based on the principle of Shariah without any exploitation. He further views that IFIs must fulfill their moral objectives and have social responsibilities. He raises his concerns on the trend of Islamic finance, which seems to deviate from its original aspiration.

Asutay (2008) maintains that the Islamic finance has failed to realize the very reason of its existence in providing socio-economic development for the larger parts of the Muslim world and communities. He further criticizes that IFIs do not serve and engage with communities but rather to serve markets (Asutay, 2010: 43). In fact, the CSR initiatives are rather limited and questionable. At this juncture, on top of commercial objective, IFIs are also expected to fulfill their social responsibilities as part of their religious and

moral obligation. As financial institution, IFIs should play active roles to improve socio-economic condition and these include alleviation of poverty, establishment of equity and justice, socially responsible investment, fostering socio-economic development, fulfillment of broad socio economic development, job creation and stimulation of entrepreneurship, investment in Real Economic Sectors.

In order to shed light on the essence of corporate governance to promote value oriented Islamic finance practices through CSR initiative, this paper proceeds as follows. The next section briefly discusses CSR in IFIs. Section three highlights CSR framework in IFIS and its unique characteristics as compared to its conventional counterpart. Section four discusses the roles of corporate governance towards better CSR practices in IFIs by advocating the pro-active roles of stakeholders, appropriate organizational and ownership structure, sound monitoring mechanism and transparency *via* corporate social reporting. The last section then concludes the discussion.

CSR in IFIs

The trend of CSR is very appealing worldwide. It has been a common practice in the market particularly for listed companies to produce their annual CSR report. Companies with good CSR record enjoy high reputation and able to attract investors especially institutional investors who are very concerned with their ethical investment. In fact, the popularity of Social Responsible Investment (SRI) has boosted the CSR initiatives worldwide. SRI is a form of ethical screen to ensure that the SRI fund does not invest in firms that have poor records of CSR. In the UK, Financial Times Stock Exchange Index introduced the FTSE4 Good Index formulated based on the CSR criteria. This is followed by the US whereby the Dow Jones Stock Exchange introduced its own Sustainability Index. These initiatives obviously indicate positive development on the needs for social dimension in investment and business activities.

Basically, the term CSR has been broadly used to refer the firms' social obligations on voluntary basis. This is in parallel with definition of CSR by the European

Commission (EC) where it refers to "a concept whereby companies integrate social and environmental concern in their business operation and in their interaction with their stakeholder on voluntary basis". Unlike the definition by the EC which is very narrow, the definition of CSR by the World Business Council for Sustainable Development (WBCSD) extends the framework by not limiting it to voluntary form of CSR. The WBCSD defines CSR as "the commitment of business to contribute to sustainable economic development, working with employee, their families and local community and society at large to improve their quality of life" (WBCSD, 2002: 6). This definition enhances the scope of CSR by including any kinds of initiatives for social purpose whether they are voluntary or obligatory

In the context of IFIs, the Association of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has issued specific standards on CSR known as Governance Standards No. 7: Corporate Social Responsibility, Conduct and Disclosure for

IFIs. The AAOIFI refers CSR as “to all activities carried out by IFIs to fulfill its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries as individual and institutions” (AAOIFI, 2010). Unlike the WBCDS and the EC, the AAOIFI’s definition further enhances the scope and foundation of CSR. The CSR is considered as not only part of IFIs contribution to socio-economic development but regarded as religious obligations and ethical consideration inspired by the teaching of *al-Quran* and *al-Sunnah*.

Despite criticism on lack of CSR in Islamic finance, a study by Farook, (2009) on CSR

trends in 29 IFIs from 19 countries however indicates significant improvement of IFIs on the CSR initiative. The report reveals that IFIs have taken numerous and significant social measures towards social responsibility in various aspects such as charitable activities, social welfare and development, environment, concentration on screening, serving and responsible dealing with customers and employee welfare. Despite the positive trend of CSR in IFIs, there are still many rooms for improvement and enhancement as the public generally unaware or have lack of information on IFIs’ CSR initiative.

Conceptual Dimension of CSR from Islamic Perspective

The basis of CSR in modern business organization is founded on several western theoretical foundations and these include Classical View Theory, Social Contract Theory, Instrumental Theory, Legitimacy Theory and Stakeholder Theoryⁱⁱ. This section offers another theoretical foundation of CSR namely Islamic Theory of CSR as formulated based on the underlying principles of *al-Quran* and *al-Sunnah*. Khan, (2007) asserts that there should be a distinctive Islamic corporate objective as opposed to the profit and utility maximization based conventional objectives where IFIs should also aim to maximize social welfare function. This can be materialized by involving in community banking, responsible and ethical finance and CSR initiatives.

Unlike theory of CSR from a conventional perspective which is based on secular humanist approach, CSR in Islam is founded on the faith-based approach namely *Tawhid*, *Shariah* and ethics. For purpose of comparison, table 1 summarizes the distinct characteristics and theoretical frameworks of CSR. This table vividly illustrates the diversities of secular and Islamic Approach of CSR by highlighting their distinct features and different theoretical foundation.

Table 1: Theory of CSR

Theory	Characteristics
Classical	Social responsibility of business

view	is to increase its profit
Social Contract	Business is part of society.
Instrumental	Social responsibility is part of the business strategy for reasons of good image, public relations ploy, firm’s competitive advantage
Legitimacy	CSR is a response to the environmental pressures involving social, political and economic forces
Stakeholder	CSR is founded on the stakeholders value oriented system.
Institutional	Role of social pressure in determining company behavior
Islamic	CSR is part of the collective religious obligation inspired by the <i>taqwa</i> dimension (God consciousness)

Source: Aribi, (2009), Dusuki, (2008) and Farook, (2007): Modified.

Table 1 demonstrates the diverse characteristics of theory of CSR from western and Islamic perspectives. The western theories of CSR are founded on the secular approach whereby it emphasizes solely on the physical reality and

human rationale. The central motivation of CSR hence is materialistic rather than ethical. On the other hand, Islamic theory considers CSR as part of the collective religious obligations inspired by the *Taqwa* dimension derived from the principle of *Tawhid*. *Taqwa* dimension is an important factor in motivating the individual to voluntarily contribute in socially responsible activitiesⁱⁱⁱ. At this point, the theoretical foundation of CSR in Islam is based on the holistic approach by combining moral, ethical, Shariah and belief. Implementing CSR is one of the ways to achieve *Taqwa* and fulfilling duty as vicegerent of Allah to achieve “*al falah*” or success in the world and the hereafter.

CSR Framework in IFIs

Despite positive development of CSR and widespread of academic interest, its theoretical framework is still elusive. Dusuki and Dar, (2007: 253) highlight the scope of CSR framework into four main areas of CSR namely from the environmental dimension, the human resource dimension, the philanthropic dimension and the human rights dimension. These four dimensional perspectives provide foundational basis to formulate CSR framework in IFIs. Another conceptual dimension on CSR categorizes social accountabilities into four layers of responsibilities namely economic, ethical, legal and discretionary. Figure 1 demonstrates these layers of responsibilities in the form of pyramid indicating the most and the least level of accountabilities.

Figure 1: CSR Model



Source: Carrol, (1979)

In conclusion thereof, there are similarities as well as fundamental differences of CSR from western and Islamic perspectives. The theoretical foundation of CSR in Islam is inspired by the *Taqwa* dimension that derived from the epistemology of *Tawhid* (Choudhury and Hoque, (2004). This holistic approach requires IFIs to perform their social responsibilities as part of collective religious obligations towards all of stakeholders. With this solid foundation, CSR should be one of the main priorities of IFIs and should be embedded as corporate culture so as to epitomize the duty of fulfilling *maqasid Shariah*.

The economic framework views CSR as a mechanism to provide returns and to maximize the shareholders wealth. The legal dimension places CSR as a regulatory requirement within the ambit of economic objectives. The ethical category on the other hand considers CSR as a vehicle to materialize the moral aspects of business. The discretionary or philanthropy dimension puts CSR as a pragmatic tool to contribute to the society through social activities and community investment.

Social responsibilities of typical financial institutions include exercising care in the use of funds, providing security guarantees to depositors, showing concerns for social needs and environment, allowing access to finance, know the customer, fighting money laundering and protecting financial privacy (Zeegers, 2001, 153-157 and Decker, 2004: 715). With the different nature of business and unique features, CSR framework in IFIs extends beyond those aspects where it consists of mandatory and recommended forms of social responsibilities as illustrated in table 2. The mandatory form of CSR is considered as religious obligatory while the recommended form of CSR as commendable and voluntary.

Table 2: CSR Frameworks

Mandatory Forms	Recommended Forms
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<ul style="list-style-type: none"> • Screening Clients for Shariah compliance • Responsible Dealing with Clients • Earning and Expenditure Prohibited by <i>Shariah</i> • Employee Welfare • <i>Zakah</i> (Obligatory Tax) 	<ul style="list-style-type: none"> • <i>Qardh al Hasan</i> (Benevolent Loan) • Reduction of Adverse Impact on Environment • Social, development and environment based Investment Quotas • Customer Service • Micro, Small Business and Social Savings and Investments • Charitable Activities • <i>Waqf</i> (Endowment) Management
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Source: Farook, (2007: 37-44).

As Islamic institutions, IFIs are obligated to operate their business and operations based on the Shariah principles and these include

screening clients for Shariah compliance, responsible dealing with clients, to ensure that income, earning, and expenditure free from prohibited elements, employees' welfare and payment of *zakah*. These are mandatory forms of CSR for IFIs as stipulated in the *Quran* and *al sunnah* which cannot be compromised at all. The recommended forms of CSR are not compulsory for IFIs and the list is not exhaustive and its framework can be in many forms as long as they comply with *Shariah* principles and Islamic ethical values. Islam nevertheless strongly encourages and commends any efforts for socio-economic justice. In this aspect, IFIs are recommended to provide benevolent loan for the needy, to invest in adverse impact on environment project, to give priority for social, development and environment based investment, to have standard customer service, to participate in microfinance and small-medium enterprises (SME) investment, to increase charitable activities and *waqf* contribution.

Roles of Corporate Governance in IFIs towards Better CSR

Basically, there are various social and economic factors involved in the formation of corporate awareness on the importance of CSR. Besides economic development status, cultural values, legal system and religious practice, corporate governance is also one of the determinant factors that contribute to better management of CSR (Farook and Lanis, 2005: 336). Stronger corporate governance through sound and proper governance framework will surely result greater accountability and transparency. The accountability then nurtures corporate awareness and responsibilities upon a large number of stakeholders. With this sense of responsibilities finally will stimulate the corporate desire to contribute to the society in order to improve socio-economic condition of the community on top of IFIs duty to protect the rights and interest of shareholders.

From theoretical perspective, regardless the agency theory or the stakeholders theory or even the stewardship theory, corporate governance is expected to function as a mechanism to reduce cost of business, to resolve agency issues and to mitigate any

potential conflict of interest in the firm. In addition to that, corporate governance is also considered essential as a key factor in shaping the IFIs direction towards active engagement on CSR. In fact, CSR may play its function to boost financial performance and to improve corporate image in the community. At this point, the empirical evidence reveals that CSR has positive relationship with corporate performance. For instance, an extensive study conducted by Pava and Krausz, (1996) on 21 empirical studies from 1972-1992 further affirmed positive association between CSR performance and corporate financial performance. At this point, issues on financial return shall not be the reason or excuse for IFIs to be actively involved in CSR initiatives. This study vividly proves that CSR has not only improved the financial performance but also portrayed good corporate image.

With an understanding that CSR has positive association with corporate financial performance, this paper suggests that corporate governance plays very imperative roles to foster and to stimulate CSR initiatives in IFIs.

The extent of corporate governance practice in IFIs reflects the commitment of the companies to protect the interest and rights of all stakeholders by taking social and economic aspects into consideration. From the view point of corporate governance, the state of CSR practices in IFIs is strongly influenced by the way they are directed, controlled, monitored

Pro-Active Roles of Stakeholders

Generally, from typical corporate structure's perspective, there are four types of stakeholders namely business stakeholder, social stakeholders and financial stakeholders (Aerts, *et. al.*, 2004). Another classification refers stakeholders into internal and external. This paper reconciles these two classifications by categorizing internal stakeholders as business stakeholders and financial stakeholders and external stakeholders such as mainstream media, regulatory authorities and non-governmental organizations (NGOs) as external stakeholders. Since external stakeholders do not have direct commercial interest in the company as in the case of internal stakeholders, they will normally be more inclined towards CSR initiatives.

The stakeholders' theory of corporate governance enhances the scope of stakeholders as described above. In this regard, Freeman (1984: 46) defines stakeholders as 'any group or individual who can affect or is affected by the achievement of the organization's objectives'. Although, this definition expands the definition of stakeholders to include internal and external stakeholders, key participants of corporate governance in IFIs mainly refer to internal stakeholders such as employees, managers, BOD, Shariah board and shareholders. The external stakeholders namely customer, consumer, regulators and investors act as a pressure group to encourage CSR. External pressure from NGOs, consumers, suppliers and media is important to affect the CSR initiatives from outside. As organizations independent from government and have no direct interest with IFIs, NGOs through campaigns and direct or indirect influence to community as well as investment communities may provide significant impact on corporate social activities.

Basically, CSR is considered as voluntary in which regulatory authorities do not interfere or

and supervised. At this juncture, this paper makes five propositions that pro-active roles of stakeholders, organizational structure, ownership structure^{IV}, monitoring mechanism and corporate social reporting are the most important factors to determine and influence the level of CSR practices in IFIs.

pass any specific legislation to make CSR mandatory. Nevertheless, regulators may play their role in stimulating the CSR initiative and provide regulatory frameworks for its implementation and practice. Although CSR is a voluntary practice, the recent development shows that regulation is necessary to boost its practices especially pertaining to workers' rights and environmental issues. Indeed, McBarnet, (2009: 27) views that sound regulatory framework can provide systematic and significant impact on CSR practices. In certain jurisdiction, regulatory authorities promote CSR through indirect regulation such as tort law to extend the legal enforceability of CSR issues and contract law to give the CSR standards, the weight of obligation (McBarnet, 2009: 31). For instance, in the UK, the government uses the disclosure tool to foster CSR practices whereby companies are required to disclose their initiative in relation with investment decisions and social, environmental and ethical considerations.

In line with the nature of corporate governance framework which is involving the internal organ of governance such as managers, and employees, Kolk and Pinse, (2010: 18) view that CSR is likely to be integrated in the firms' CSR policies pertaining to internal aspects such as employee conditions and ethical behaviour of managers and employees. They further opine that corporate governance would put much less emphasis on the external framework of CSR such as environmental and community issues (Kolk and Pinse, 2010: 19). The external framework of CSR is normally influenced not from the internal stakeholders but coming from outside stakeholders such as investors that concern with the socio-economic and environmental issues. These external stakeholders could potentially boost the CSR initiatives, as the companies would try to attract these kinds of investors.

In the case of IFIs, the internal stakeholders refer to the same organ of governance in typical companies' structure and these include employees, managers, BOD and shareholders. Additional stakeholder which is prevalent and unique in the IFIs corporate structure refers to the institution of *Shariah* board. In the meantime, external stakeholders may play the same roles as in other kinds of corporation to act as a pressure group and to provide appropriate framework for the CSR practices.

Since CSR is relatively new to IFIs, it is hard to find a comprehensive study on the extent of CSR practices. Some studies although not comprehensive, provide certain interesting findings on the stakeholders' perception upon CSR. A study conducted by Dusuki and Dar, (2007: 261) on 1500 respondents consist of seven different stakeholders namely customers, depositors, local communities, employees, branch managers, regulators and *Shariah* advisors revealed that stakeholders of IFIs have positive views on CSR and in fact they considered it as one of the most important criteria in their banking selection decisions. In addition, senior manager's personal values and management policy and initiatives are also amongst the important factors to determine the extent of CSR practices in IFIs.

Any effort and endeavor on CSR initiatives adheres most to its key players within the corporate governance structure of the organization. This raises an issue as to the need for integrated approach for such purpose. At this point, several key participants of corporate governance either external such as regulatory and supervisory authorities or internal as in the case of BOD, shareholders, managers, employees and *Shariah* board are considered very important. Their responsibilities to promote, to implement, to practice and to enforce CSR are summarized in table 3.

Table 3: Key Participants of CSR

Stakeholders	Functional Roles
Regulatory Authority	To set regulatory framework for sound and proper code of ethics - Code of ethics on corporate governance for general usage
Supervisory	To supervise, monitor and enforce

Authority	the implementation of code of ethics - Enforcement of the code of ethics
Shareholders	To ensure that all investments and business activities are Shariah and ethically permissible - Incentive for ethical achievement
Shariah Board	To ensure Shariah and ethical compliance - Assist the BOD to come out with Code of Ethics - Emphasize on ethics in the process of issuing Shariah rulings
BOD	To set the IFIs direction and policies on ethics - Code of Ethics for internal usage - Ethics as a basis of decision making
Management	To implement set of ethical policies set by the BOD - Organizing ethics training - Module for ethics programme - Enforcement of ethics
Employees	To practice and comply with the code of ethics - Ethics as a culture
Community	Pressure Group to encourage CSR - External pressure from NGOs, consumers, suppliers and media.

To further illustrate the stakeholders' responsibilities to foster CSR in IFIs, table 4 highlight CSR frameworks in seven areas. All stakeholders particularly BOD, shareholders, managers, employees and Shariah board have their own functions to implement and foster CSR. For this purpose, it is important to have integrated governance policy and framework on the implementation of CSR. Continuous and effective interaction between the stakeholders will surely lead to increasing societal awareness and concern upon any issues pertaining to CSR.

Table 4: CSR Framework and Stakeholders Responsibilities

CSR Framework	Implementation	Main Stakeholder Responsibilities
Employee Welfare	Equal Opportunities	BOD
	Training and Developments	Managers
	Employee's benefit	BOD
	Indemnity and Pension	BOD
	Workplace environment	Managers
Community	Community Investment	BOD
	Education Support	BOD
	Health Support	BOD
	Qardh al Hasan	BOD
	Social Activities Support	Managers
Philanthropy	Charity and donation	Shariah Board
	Zakah	Shariah Board
	Waqf Management	Shariah Board
Product and Services	Quality of the products and Services	Shariah Board
	Micro, Small Business and Social Savings	Managers

Organizational Structure

The existence of Shariah board within the internal corporate governance structure shall be the advantage for IFIs to further promote the implementation of CSR. Shariah board is also expected to take into consideration the moral and social objectives. A study conducted by

CSR Framework	Implementation	Main Stakeholder Responsibilities
	and Investments	
Customer	Consumer-friendly products and services	Managers
	Customer satisfaction	Employees
Environmental Issue'	Support of environmental initiative	BOD
	Reduction of Adverse Impact on Environment	BOD
	Social, development and environment based Investment Quotas	Managers
Shariah Issue	Screening Clients for <i>Shariah</i> compliance	Shariah Board
	Maqasid <i>Shariah</i> as the Main Consideration	Shariah Board

Table 4 summarizes the CSR frameworks applicable to IFIs and the main actors to implement and boost CSR initiatives. In relation with the roles of corporate governance, this section explains separately the functions of internal stakeholders and as to how they can foster the implementation of CSR. Although, the external stakeholders are also important to influence CSR from outsides, in the context of corporate governance in IFIs, this paper views that the internal stakeholders particularly BOD, managers, *Shariah* board and employees are the main component of CSR factors.

Farook and Lanis, (2007: 240) reveals that the existence of Shariah board is one of the significant factors to foster CSR disclosure practice. The study finds that Shariah board which consists of interdisciplinary memberships, doctorate qualification and

international reputations results in greater supervision and monitoring and hence showing higher level of CSR disclosure. Based on this finding, the study suggests four main factors that lead to positive association between the existence of Shariah board and CSR practices. Shariah board with more board members, cross memberships, secular educational qualifications and reputable scholars are found to be more proactive to influence IFIs on CSR.

As the highest authority in IFIs, the BOD has responsibilities to design corporate strategies by considering the interest of all stakeholders and this includes influencing the company's social obligation. At this point, board structure and composition is one of the factors that may determine the extent of CSR initiatives in IFIs. Board with more independent directors is presumed to have better monitoring and supervision of company's activities and action of managers. On the other hand, board with more executive directors and insider directors is considered less effective. Outside directors provide more resources, legitimacy and information which is important to stimulate the CSR initiatives (Ayuso and Argandona, 2007: 8) in IFIs^{vi}.

Moreover, board diversity with different gender, ethnicity, experiences and cultural background can also be significant influential factors to promote CSR (Ayuso and Argandona, 2007). A study conducted by Ibrahim and Angelidis, (1994) reveals that female directors are more sensitive to CSR. This is affirmed by other studies such as Coffey and Wang, (1998), Williams, 2003 and Webb, (2004)^{vii}. In fact, non-shareholder stakeholders in the BOD such as academic, politicians and retired government officer are also found to be more keen to protect not only the interest of shareholders but to take into consideration social responsibilities^{viii}.

While the existing studies and empirical evidence vividly indicate that board diversity is one of the key factors to influence CSR

Ownership Structure

Ownership structure is of critical importance to the effectiveness of corporate governance. Generally, there are two types of ownership structures namely insider ownership or

managerial ownership and block holder's ownership or institutional ownership. Based on the nature of the managerial ownership, which is owned by individual, IFIs are likely to initiatives, the practice in IFIs seems to show otherwise. The board room of IFIs particularly in GCC countries is still male territory. Even though female directors are expected to be more sensitive to social responsibilities and in fact more meticulous in making decision, the existing practices demonstrate that the board room is still dominated by male directors. A study by International Finance Corporation (IFC), the private sector arm of the World Bank Group and Hawkamah, the Institute for Corporate Governance reveals that majority of banks in the Middle East and North Africa region indicated that they do not have a single female board member. The finding on this is further illustrated in table 5.

Table 5: Number of Women on the Board.

Number of Women on the Board (74 Banks: IFIs and Conventional Banks)	Percentage
2 to 5	1.50%
1	20.90%
0	77.60%

Source: IFC and Hawkamah, (2008: 32): Modified

As can be clearly seen through the figures, the board diversity in term of gender has not been a common practice yet by IFIs and even conventional banks in the Middle East and North Africa. This is perhaps amongst others contributed by cultural background and social condition of the society in the Arab world. Considering to the importance of board diversity and equal opportunities regardless of gender, races and religion, the existing practice of having male directors only in the boardroom of IFIs should be changed and transformed towards more dynamic and open corporate governance practice.

operate on excessive profit-motive orientation and thus may lead to lack of CSR. On the other hand, in the case of block holder's ownership or institutional ownership such as such employees' provident fund, pension fund or government linked company, IFIs are likely to invest not only in business that may provide higher returns but also may contribute to socio-economic, community and environment. This is affirmed by a study on 86 Malaysia companies in Ghazali, (2007) which reveals that government ownership has significantly influenced the CSR disclosure practice. This is because IFIs with block holder's ownership have responsibilities to satisfy and to protect rights and interest of a large number of individuals such as taxpayers and pensioners.

Monitoring Mechanism

Having a sound framework of corporate governance to foster CSR is meaningless without support of proper monitoring and supervisory mechanism. Corporate governance committee within the internal structure of corporate governance in IFIs is necessary for purpose of supervision and monitoring CSR practices. In this regard, the IFSB Guiding Principles on Corporate Governance recommends the establishment of corporate governance committee in IFIs for purpose of governance monitoring and supervision. This corporate governance committee will specifically monitor the IFIs' compliance with their governance policies and initiate any effort to improve them.

On top of corporate governance committee, it is also good practice for IFIs to dedicate specific staff or CSR manager to deal with any CSR initiatives including monitoring and supervision. In the US for instance, the practice of appointing dedicated CSR managers or ethic officers is becoming popular (McBarnett, 2009: 2). Although, it is not a common practice in IFIs to appoint specific officer or CSR manager to in charge CSR matters, such initiative is expected to positively influence the CSR activities. The CSR manager will be able to allocate ample time and necessary efforts to plan, initiate and monitor any CSR initiatives in IFIs.

In view of the uniqueness of corporate governance structure in IFIs, the institutionalization of Shariah board offers

In the context of IFIs, the deposit structure also one of the factors that influence the CSR practices in IFIs. Farook and Lanis, (2007: 231) suggest that the size of Investment Account Holders (IAH) fund in IFIs is one of the determining factors upon the level of CSR practices. The percentage of CSR initiatives is larger to IFIs that having significant IAH funds as compared to those having small amount of IAH funds. This is because the IFIs with large amount of IAH funds have to prove to investors including shareholders and depositors particularly IAH as a quasi-shareholders on the credibility and social functional roles of IFIs towards community.

another important mechanism to monitor, supervise and even to foster CSR practices. Shariah board can play a role as *hisba*^{ix} institution during the pre-modern Muslim societies but dresses with new approach and strategy in modern Muslim societies. At this point, the institution of the Shariah board is an important organ of corporate governance in IFIs to function as the *muhtasib* (ombudsman) or internal supervisory authority on the aspect of Shariah and CSR practices.

Despite the significance of Shariah board to supervise and monitor the CSR initiatives and implementation, the existing practice evidences that majority of Shariah scholars are unable to locate ample time for such responsibilities. As a result, Shariah board is more concerned on the legal mechanistic of *fiqh* in issuing Shariah pronouncements rather than taken into consideration their implication to socio-economic condition including CSR. The release of "Shariah Scholars-A Network Analytic Perspective" issued by the Funds-at-Work provides the extent of current Shariah board practices in IFIs. The survey in 2008 reveals that out of 94 scholars in 467 IFIs in 19 countries, only 20 of them are heavily utilized where they represent 339 board positions equaling 17 board positions per scholar. This figure is increased in 2009 where it shows that the top 10 listed Shariah scholars have monopolized more than 58% out of 956 Shariah board positions in 271 organizations in 22 countries. The recent analysis in 2010

further evidences that the top 10 scholars hold 67% out of 1054 board positions in 291 IFIs in 24 countries.

In view of the above findings, the existing practice needs a corporate governance reform to ensure the effectiveness of Shariah board in playing its functional roles as well as to promote CSR initiatives in IFIs. For instance, the Shariah Governance Framework issued by

the Central Bank of Malaysia (BNM) put condition of at least five members for each Shariah board in IFIs and Shariah scholars are not allowed to sit in more than one board at a particular time. This regulatory initiative will promote a good practice of corporate governance in IFIs and at the same time enables Shariah board to mobilize its function to foster CSR practices in Islamic finance industry.

Transparency and Corporate Social Reporting

The hallmark of corporate governance is transparency. The element of transparency is important for IFIs and it is one of the pillars of good practice of corporate governance. With regard to CSR, good corporate governance requires IFIs to disclose their CSR activities either in the annual report or any other avenues. The disclosure on CSR initiative will inculcate confidence of the stakeholders upon the contribution made by IFIs towards community at large. The trend of CSR disclosure through standard reporting is becoming popular. It is reported that 90 of the top 100 European companies and 59 of the US top 100 have published their CSR reports in 2005-2006 (Context, 2006: 10).

Generally, there are four types of CSR Reports in practice namely Social Responsibility Report (SRR), Sustainability Report (SR), Ethical Consumerism Report (ECR) and Environmental Policy Report (EPR). SRR and SR are the most famous forms of CSR reports. Hackston and Milne, (1996: 78) defines CSR report as the provision of financial and non-financial information relating to the firm’s interaction with physical and social environment as recorded in the annual report or corporate social report and these includes information on environmental issues initiatives, energy, fair business practices, human resources and community involvement.

Considering the importance of unified or standard CSR report to systematically foster CSR initiatives, the United Nation Environment Programme has developed Global Reporting Initiative (GRI), a standard guideline for global corporate social reporting. This is followed by the Accountability AA1000 Assurance Standard developed by London-Based organization, the Institute of Social and

Ethical and Accountability (ISEA). In view of some distinct characteristics with typical corporate entities which make the existing international guidelines insufficient for IFIs, the AAOIFI has also made an initiative to issue the Governance Standard for CSR. This AAOIFI Governance Standard provides guidelines and guiding principles for IFIs by combining the voluntary and obligatory frameworks of CSR.

CSR report is a key tool for communicating with stakeholders in providing information pertaining to corporate social activities such as involvement in community development and education and efforts on employees’ protection. Unlike in conventional, there is no specific and intensive study on the trend of CSR reports in IFIs except several researches on the general disclosure of social activities. For instance, Farook and Lanis, (2007), conducted a study on the social disclosure level of 47 IFIs from 14 countries from two dimensional perspective of social responsibility and sense of community. As expected, the study reveals that majority of IFIs have significantly low level of social disclosure indicating the weak practice of CSR disclosure. This is affirmed in Dar and Ahmad Azami, (2010: 49) as illustrated in table 6.

Table 6: Information on CSR on IFIs in the GCC

IFIs	Social Responsibility	Sense of Community	Total Max (10)
Noor Islamic Bank	0	3	3
Dubai Islamic Bank	1	3	4

Dubai Bank	0	3	3
Bank Al Bilad	0	3	3
Al Rajhi Bank	3	3	6
Bahrain Islamic Bank	0	3	3
Kuwait Finance House	0	3	3
Shamil Bank	0	3	3
Qatar International Islamic Bank	0	3	3
Qatar Islamic Bank	0	3	3

Source: Dar and Ahmad Azami, (2010: 49)

The above figures show that CSR disclosure is not prevalent practice to IFIs in GCC countries. Perhaps, this phenomenal is contributed by either lack of awareness or less support from the regulatory authorities. Another assumption is that there is no pressure group as in the case of other jurisdictions such as in the US and the UK to influence the CSR initiative in GCC countries. The negative findings on CSR practice in the GCC countries are regrettable. With a high level of economic development and income especially from oil ad gas industry, IFIs in GCC countries should grab this golden opportunity to move beyond considering economic objectives as the sole motive to the importance of improving non-economic consideration via CSR initiatives.

Another interesting study is conducted by Aribi, (2009) who examined the disclosure pattern of 21 IFIs in GCC Countries. Similar with the previous study, Aribi, (2009) affirmed that the disclosure practice in IFIs was significantly low. This study provides detail analysis about the contents of CSR disclosure and these include commitment to CSR, employees, philanthropy, community, product and services, customers, environment and values and ethics. The findings in this study are summarized in table 7.

Table 7: Disclosure Practice on CSR in IFIs

Disclosure		Percentage (21 IFIs)
Commitment to CSR	Statement on CSR	57.1%
Employees	Equal Opportunities	9.5%
	Training and Development	80.9%
	Employee's Benefit	80.9%
	Work Environment	4.8%
Community	<i>Qardh al Hasan</i>	23.8%
	Social Activities	4.8%
	Health Support	9.5%
	Contribution to National Economy	38.1%
	Community Investment	28.6%
Philanthropy	Charity and Donation	42.9%
	<i>Zakah</i>	85%
Product and Services	Quality of the Product	42.9%
	Product Innovation	42.9%
Customers	Customer Service	66.6%
	Meet Customer Needs	28.6%
	Customer Satisfaction	42.9%
Environment	Environmental Issues	0%
Values and Ethics	Islamic Ethics	85.7%
	Ethical Conduct	19%
	Adherence to Islamic Principles	100%

Source: Aribi, (2009: 114-162).

The findings in the above study reveal some interesting information. As to the disclosure on commitment to CSR, the study reveals that 57% of IFIs mentioned in the annual report about their position in this aspect. In term of employees' issues, majority of IFIs disclosed training and development and employee's benefit while only minority of IFIs disclosed equal opportunities and work environment. In addition, surprisingly, none of IFIs disclosed information on any initiatives pertaining to environmental issues. While Islam strongly emphasizes on environmental responsibilities, IFIs on the other hand is seen weak in this aspect.

Another aspect pertaining to community, the disclosure practice is very low for *qardh al-hasan*, social activities, health support, and contribution to national economy and community investment. With respect to

philanthropy, significant percentage of IFIs disclosed information on *zakah* while only 42.9% disclosed on charity and donation. The information on *zakah* and charity is essential for IFIs particularly to the external stakeholders as IFIs are expected to contribute to society and community. Lack of disclosure on this aspect may create wrong perception on the roles of IFIs.

Table 8 illustrates the difference of disclosure practices of CSR in 20 IFIs in Malaysia, Qatar, Kuwait, UAE, Bahrain and Kingdom of Saudi Arabia. This table classifies the disclosure practices into five aspects namely CSR Report in Annual Report, Policy or statement on CSR, Initiatives on community awareness and education, participation for community development and description of contributions to charitable activities.

Table 8: Disclosure Practices of CSR in IFIs

IFIs	CSR Report in Annual Report	Policy/ statement on CSR	Community awareness or education	Community development	Description on charitable initiatives
Bank Islam (M) Berhad	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Hong Leong Islamic Bank	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Bank Muamalat Malaysia Berhad			<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Al Salam Bank	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Ahli United Bank		<input checked="" type="checkbox"/>			
Ithmaar Bank	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Kuwait International Bank					<input checked="" type="checkbox"/>
Bank of Kuwait and the Middle East		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>
Boubyan Bank					<input checked="" type="checkbox"/>
Investment Dar		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>
Kuwait Finance House	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Al Rayan Bank		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Qatar International Islamic Bank					<input checked="" type="checkbox"/>
Qatar Islamic Bank	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>

Amlak Finance				<input checked="" type="checkbox"/>	
Dubai Islamic Bank		<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	
Emirates Islamic Bank					
Bank Al-Jazira	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Al Rajhi Bank	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	
Bank Al Bilad		<input checked="" type="checkbox"/>			

Out of 20 IFIs, only 8 IFIs published their CSR Report in the annual report. 15 IFIs have a clear statement and policy on CSR, which is stated clearly on their websites about CSR commitment and initiatives. 7 IFIs disclosed their CSR initiatives on community awareness and education. 13 IFIs disclosed their participation on community development. 15 IFIs disclosed in details the description of contribution to charitable activities. These figures obviously indicate the low level of disclosure practice of CSR in IFIs particularly on the aspect of social reporting. More than 50% of IFIs have failed to produce CSR report

in the annual report indicating very weak practice.

Unlike table 8, figure 2 demonstrates the trend of CSR disclosure practice from country specific behavioral perspective. Graph below clearly illustrates the extent of CSR disclosure of IFIs in Kuwait (5 IFIs), Bahrain (3 IFIs), Malaysia (3 IFIs), Qatar (3 IFIs), UAE (3 IFIs) and Saudi Arabia (3 IFIs). This illustration is beneficial for purpose of country specific analysis and to provide comparative perspective on the CSR disclosure practice in these six jurisdictions.

Figure 2: CSR Disclosure Practice from Country Specific Behavioral Perspective

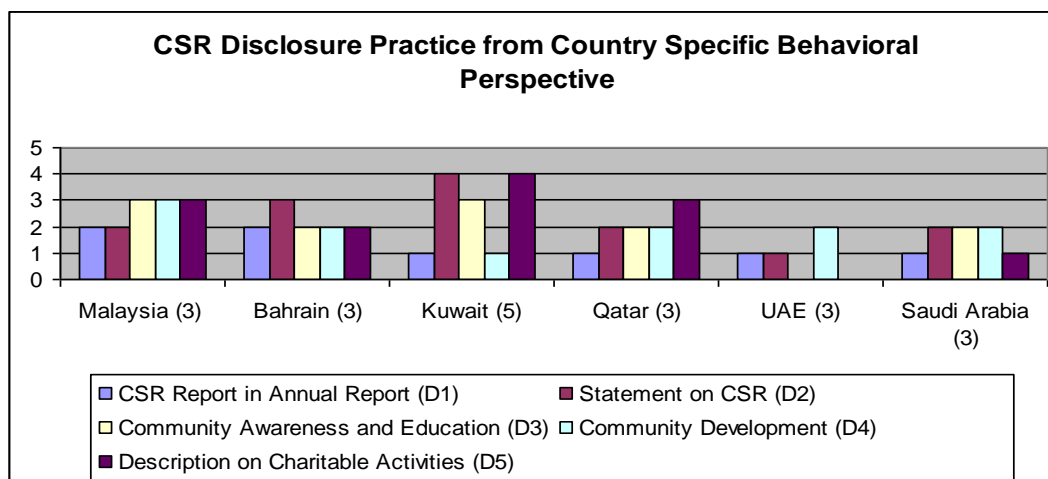


Figure 2 reveals that all IFIs in Malaysia disclosed information on D3, D4 and D5, followed by Bahrain on D2 and Qatar on D5. Weak practice is shown by IFIs in Kuwait, Qatar, UAE and Saudi Arabia whereby only 1

IFI respectively issued or published CSR report. In fact, in UAE, none of IFIs disclosed information pertaining to community awareness and education and description on charitable initiatives. The overall results also

depict that Malaysia and Bahrain slightly have better CSR disclosure practice as compared to Kuwait, Qatar and Saudi Arabia. Although IFIs in UAE are amongst the pioneer in Islamic finance such as Dubai Islamic Bank, the result nevertheless indicates otherwise where the overall CSR disclosure practice is rated as very low.

While IFIs are expected to be transparent, the existing practices nevertheless show otherwise. Moreover, transparency and corporate disclosure particularly on CSR are not common

Concluding Remarks

This paper aims at providing an overview of corporate governance on CSR in IFIs as part of their ethical responsibilities. The Islamic ethical dimension denotes a solid epistemological orientation for IFIs as motivation to fulfill these ethical responsibilities via CSR initiatives. To sum up, corporate governance is an important mechanism and one of the factors that determine and influence the IFIs' initiatives on CSR. Strong corporate governance with proactive roles of stakeholders, appropriate organizational structure, ownership structure, sound monitoring and supervisory frameworks and proper corporate social reporting would be able to stimulate and induce the IFIs to play more roles in social and moral initiatives.

In view of lack of CSR disclosure practices in IFIs, this paper strongly advocates any efforts and endeavors to promote transparency and disclosure on social responsibilities. Numerous CSR efforts and initiatives of IFIs are insufficient or even to certain extent meaningless in the context of commercial or business entity. These initiatives must be supported with significant disclosure through

in IFIs and in fact very weak. The lack of CSR disclosure in IFIs then must be overcome by facilitating its initiatives with sound regulatory frameworks and certain incentives. In Islam, disclosing social information for the reason of transparency and accountability is perceived as social obligation. In fact, the disclosure on CSR initiatives is regarded as religious obligation rather than moral obligation per se. In this regard, transparency via corporate social reporting is deemed important as part of good corporate governance practices.

strengthening proper reporting structure and format and any other disclosure avenue. Transparency must be part and parcel of IFIs in which stakeholders and general public may access to the information on CSR disclosure. This factor will further generate confidence of the stakeholders on the roles play by IFIs in mobilizing their funds and investments.

This paper supports its arguments with proactive initiatives and efforts by IFIs in promoting and inculcating value-oriented Islamic finance practices. Despite numerous challenges and problems, IFIs has successfully proven that such initiatives are possible and workable. A wider framework of CSR with the support of various stakeholders including the influential roles of *Shariah* committee is a determinant factor that will enhance the corporate socio-economic dimension. Through clear policy and standard operational procedures and guidelines beyond the legal mechanistic of *fiqh muamalat*, IFIs are able to transcend the existing Islamic finance paradigm towards value-oriented and *maqasid al-Shariah*-based practices.

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Notes:

- ⁱ Dusuki and Dar, (2005: 391-392) highlight four main factors that lead to the emergence and initiative of CSR namely Growing Market Pressure, Regulatory Pressure, Power of Communication and Competitive Advantage. These inherent factors also affect the IFIs to be more socially responsible and in fact as Islamic institutions, the social responsibility is considered as collective religious obligation.
- ⁱⁱ Garriga and Mele, (2004) classify the theory of CSR into four namely Instrumental Theories, Political Theories, Integrative Theories and Ethical Theories. This section nevertheless further classifies the theory of CSR into Classical View Theory, Social Contract Theory, Instrumental Theory, Legitimacy Theory, Stakeholder Theory, Institutional Theory and Islamic theory.
- ⁱⁱⁱ *Taqwa* means harmonizing and integrating material well-being and moral-spiritual values that determine their fate in the world and hereafter (Hasan, 2002, as cited in Dusuki, 2008). *Taqwa* denotes other important Islamic principles of human dignity, free will, equality and rights and trust and responsibility.
- ^{iv} Haniffa and Cooke, (2005) view that CSR reporting is significantly associated with multiple directorships and foreign ownership factors.
- ^v There are 500 verses in al Quran, relate to environmental issues. Allah says “ do not mischief on the earth, after it has been set in order, and invoke Him with fear and hope, Surely Allah’s mercy is ever near unto the good-doers” *Al Quran*, (7: 6).
- ^{vi} Several studies affirmed the positive correlation between outside directors and CSR. Ibrahim and Angelidis, (1994) found that outside directors are tend to be more in favor with the social activities and company’s initiatives on community, environment and social needs. Zahra, et. al., (1993) and Johnson and Greening, (1999) revealed that firm with outside directors are more socially responsible. This is affirmed by Webb, (2004).
- ^{vii} It is also found that the UK-based companies with female board members have good practice of corporate governance as compared to the companies with all male directors (IFC and Hawkamah, 2008: 32).
- ^{viii} Kassinis and Vafeas, (2002) found the firm with non-shareholder stakeholders was unlikely to violate the environmental laws.
- ^{ix} A term used by the classical Muslim jurists to describe the function carried out by the state or appropriate Islamic authority to regulate the market place for purpose of maintaining social justice.