



The Challenges Faced by Integrating Islamic Corporate Governance in Companies of Gulf Countries with Non-Islamic Companies Across Border through Merger and Acquisition

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Abstract

One method of achieving company expansion to address new markets and access cheaper funds is through international mergers and acquisitions (M&A). The companies in the Gulf zone following Islamic principles are keen to engage with non-Islamic companies, for example, European companies to access the benefits of globalization. However, for such takeover to succeed, congruence between the organization culture and the control system is necessary. The potentially diverse external legal and political environments can generate areas of concerns, which can only be addressed through harmonization of the corporate and financial governance of such organizations. There is a considerable body of literature on differences between Islamic and conventional corporate governance (CG), especially on financial models. However, not much research has been conducted on international M&A between companies following Islamic and the conventional CG. Such research is necessary, especially between different Islamic countries, to better the understand critical issues and let companies make more informed decisions. This study investigates the variation and extent of the *Shariah* CG code compliances among Islamic companies in three Gulf countries, namely Saudi Arabia, Kuwait, and the United Arab Emirates, and how it affect international cross-border M&A among the companies with the western ones. It was found that despite the strong economic and cultural ties between the Gulf countries states; there was diversity in the application of Islamic law within the selected countries and its effect on the international M&A. This paper can provide some insights view in controlling and organizing the M&A activities between Islamic and non-Islamic financial institutions, as the Islamic governance in practical terms, cannot be viewed as an identical homogenous practice across the Islamic domain. Cultural variations do exist.

Keywords: Corporate Governance; International Merger and Acquisition; Gulf Countries; Islamic Corporate Governance; Mergers and Acquisitions Barriers; Cultural Variations in Islamic Governance

1. Introduction

The corporate governance (CG) is a global concept that initially addressed the conflict of interest issue between management and shareholders and has been discussed over the past two decades (Cadbury, 1992; OECD, 1999; Tricker, 2015). Recently, CG has covered wider issues not only in developed countries but also in developing countries (Baydoun et al., 2012). It is a key factor affecting business organization success that desire to enhance its reputation and continue its growth and expansion (Kim, 2008; Hoontrakul and Karnchanasin, 2010). During the financial crises that occurred in 2008, various companies around the globe were affected, which posed a big challenge not only businesses but also government organization as well. This has affected the confidence of shareholders and stakeholders, which has brought to the need of sound governance practices (Parker, 2005; Pierre-Louis, 2009).

The organization for economic cooperation and development (OECD) and the World Bank contributed to this area by introducing acceptable programs and standards of CG for developed and developing countries. There is a continuing focus on the health and development of CG standards that favor or hinder economic growth and making investment decisions (Cornelius and Kogut, 2003). The World Bank (2010) reported that “Weak CG frameworks reduce investor confidence and can discourage outside investment.” On the other hand, good performance and satisfaction among stakeholders can be attributed to good CG practices (Monks and Minow, 2004). Therefore, there is a need to continuously formulate, review policies, and standards of CG to meet its main focus.

In recent years, the Islamic Financial Services Board (2015) reported that the Islamic finance industry has attracted investors worldwide, which has led to increase in its business and economic activities both regionally and globally. Furthermore, they reported that the evidence was attributed to its double-digit compound annual growth rate of 17% between 2009 and 2013. In addition, the industry’s assets are estimated to be worth USD1.87 trillion as at 1H2014, having grown from USD1.79 trillion as at end-2013 as they reported. The Arabian Gulf region accounts for 37.6% of the industry assets, and a market value of US\$ 564.2 billion of the total global Islamic financial assets. However, there is a need to review its CG and how it affects or attracts foreign investors for better international cross-border mergers and acquisitions (M&A).

The Islamic (*Shariah*) principles of business have gained prominence, especially after the financial crises that halt businesses and economic activities globally (Onagun and Mikail, 2013). Farook and Farooq (2011) stressed that *Shariah* governance becomes the guidelines for the Islamic finance industry and has been increasingly analyzed and scrutinized by stakeholders across the industry. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) provided a guidance principle for Islamic companies to follow in evaluating their *Shariah* practices (standards) and to develop the governance framework of *Shariah* with the available resources (Abdullah and Chee, 2010).

Abu-Tapanjeh (2009) argued that Islamic principles are entirely compatible with the global CG principles and guidelines, but the processes and practice may be different. The author also emphasizes that following *Shariah* principles in establishing business entities contribute to public confidence in promoting sound governance practices. Therefore, there is need to review the processes and practice for better improvement on international cross-border M&A.

There are emphases that CG of a particular country is shaped by its culture, history, and religion (Haniffa and Cooke, 2002; Licht et al., 2005). This implies that organizational activities in different countries are characterized by different dimensions such as education, religion, and traditions, which in turn affect their decisions on their cultural background and ethical perspectives (Haniffa and Cooke, 2005; McGuire et al., 2011). Thus, Gulf countries which are Muslims considered these dimensions when they adopt CG framework to reflect cultural and religious dimensions (Baydoun et al., 2012). Therefore, it is important to review how culture and religion adoption of CG reflect the entire dimension across international cross-border M&A.

In Islamic countries, the religion promotes ethical behavior of the society as it is widely recognized that there is no distinction between religious and secular affairs (Islam and Hussain, 2003; Williams, 2008). Based on international cross-border M&A, Gulf countries companies may pose challenges for CG with non-Muslim countries companies. Furthermore, most of the Gulf companies are interfered and dominated by Family-owned businesses, government intervention in the private sector, political system based on monarchies, legal system based on Islamic law, rules and regulations that must be followed by Islamic society (Al-Nodel and Hussainey, 2009). Even there is variation among countries in terms of business policies, leadership style, and management of CG, which cannot be uniformly adopted (Licht et al., 2005). Moreover, the issue of CG needs to be principles base rather than rules and regulations and has been debated among business communities and leaders (OECD, 2004). These suggest that certain CG practices and transactional practices in Gulf and Western countries can be different based on differences in cultural and religion structure. Therefore, the variations in the culture and religion can be a deciding factor in the application of CG code and the expansion of the businesses from the local border to the international borders.

Likewise, Porta et al. (2007) developed and tested the legal origins and showed that cultural and political factors support in explaining the economic consequences across countries. These factors are significant in the adoption of better governance practices, which may improve better corporations among companies globally (Weitzel and Berns, 2006). Bris et al. (2008) found that there is a high correlation between good practices of CG adopted by single firm and cross-border M&A. A similar result was found by Martynova and Renneboog (2008) concerning the link between transparency and cross-border M&A. This will enable companies globally to successfully penetrate the markets and increase their business activities (Moeller and Schlingemann, 2005). There is need to assess and evaluate all the legal and CG standards on how it may affect an efficient international cross-border M&A.

Therefore, this paper discussed the current state of *Shariah* CG practices of Islamic financial institutions in three gulf countries Saudi Arabia, Kuwait, and the United Arab Emirate. It also examines the culture and religion consideration of the management for the establishment of cross-border M&A. Furthermore, it explores the variations in applications of *Shariah* (Islamic)-based CG across Gulf countries which may have considerable implications on the cross-border M&A with non-Islamic financial institutions.

2. Literature Review

2.1. What is CG?

There is a wide range definition of CG, which depend on (1) which CG system has been adopted in different countries, (2) the country regulatory or the jurisdiction, and (3) the model of CG that is functioning in specific country.

A broader definition of CG was presented by Sir Adrian Cadbury, head of the Committee on the Financial Aspects of CG in the United Kingdom: As “the system by which companies are directed and controlled” (Cadbury Committee, 1992). Another definition has gone a step further by explaining the CG as “set of relationships between a company’s management, its board, its stakeholders and other stakeholders” (OECD, 1999).

In contrast, Elasrag (2014) has noted that CG concept from Islamic perspective does not vary much with conventional CG as it defines to a system by which firms are controlled and directed with a purpose to attain the objective of corporation by securing entire rights and interests of stakeholders. Within the Islamic paradigm, the CG context provides varied features and characteristics in contrast with conventional system as it defines as a special case of a wider theory of decision-making that utilizes the Islamic socio-scientific epistemology, which is premised on divine God oneness.

A number of researchers including Aguilera and Jackson (2010) and Claessens and Yurtoglu (2012) debated the question whether a common, international framework of CG is optimal for all countries is raised to analyze CG from a cross-country perspective. Concepts such as transparency and discloser vary from country to country regarding their legal, cultural, and economic foundations.

However, these definitions have different concepts in practices and principles based on various dimensions such as geographical location, culture, and religion. There is need to understand these variations so as to harmonize it for the improvement and better CG globally.

2.2. *Shariah* CG

Public policy debates have drawn attention on CG from an Islamic religion perspective and practice to observe the religious and cultural factors that guide the Islamic CG model (Chapra and Ahmed, 2002; Elasrag, 2014). The development of *Shariah* model of CG can help in better growth and expansion as the Islamic structure of CG has unique features in a way, which are based on decision-making theory in a wider sense. The theory is based on the concept of Islamic philosophy and Islamic belief known as *Tawhid* “oneness of God” (Hamid and Sa’ari, et al., 2011). The guiding principles of CG are based on the belief that everything that has been created by almighty “Allah” is for a specific purpose and also human beings have been created to rule the world. Since human beings are answerable to the almighty,

people who are involved in organizations are also answerable to the almighty (Chapra, 2007). Thus, in Islamic CG, organizational management aims and objectives also meet the objectives set by the almighty Allah.

CG model of Islam has unique features and characteristics, which are slightly different from the western concept, and this could present difficulties in practice (Hasan, 2009). Islamic perspective of CG comes from Islamic epistemology to premise on the divine oneness of God (Choudhury and Alam, 2013). It seems neither the AAOIFI nor the IFSB provided a clear statement of Islamic CG because of the uncertainty and different understanding of the meaning of *Shariah* CG. Therefore, it can be said that CG from Islamic perspective is unclear in terms of adoption and implementation; first, because most Islamic countries such as countries in the Gulf region have inadequately documented and implemented the Islamic CG. Second, there are no written rules and regulations to govern Islamic corporations as it is derived from Islamic religion principles. This is because Islam allows its follower; basically *Shariah* scholars to interpret *Quranic* text and *Hadith*; therefore, there is a difference of opinion on an issue.

Despite the fact that there are many common features between the conventional and Islamic CG, Islamic CG has distinct unique characteristics in comparison with the western concept of CG (Hassan, 2009). Therefore, looking at the variations between the Islamic CG and the Conventional CG is important in blending and improving CG across international cross-border M&A.

2.3. The impact of *Shariah* law on the practices of gulf countries

Shariah law greatly affects the aspects of the CG in the Islamic financial institutions in the Gulf region. It set out the CG structure, its processes as well as its administration to make sure that the entire activities are in accordance to *Shariah*. It also helps to recognize the workings related to the *Shariah* reassessment, inspection, threats administration as well as investigation (Haqqi, 2014). Furthermore, we have seen the impact of *Shariah* on the Islamic financial industry by an increase in their market value over US\$262.6 billion annually (Wilson, 2008). The positive impact of the *Shariah* law also gives confidence to the sustainable economic improvement that is derived from the strategy of the *Shariah* law fairness as well as protect life of an individual and society as a whole (Sairally, 2007; Khan and Bhatti, 2008).

In Islam, business enterprises are needed to be more see-through in their revelation exercises, not simply showing their legitimacy to group of people, as recommended by previous studies on corporate social disclosure (Haniffa and Cooke, 2005). This see-through generate to attain the notion of Islamic social reporting, which in general comprises of communal responsibility as well as full revelation (Othman et al., 2009). Some studies of Islamic corporate reporting recommended that Islamic corporations have to give true facts and figures connected to communal matters (Maali et al., 2006; Farook and Farook, 2011). However, no empirical study has endeavored to explore the definite practices of communal revelation by Islamic banks of Gulf countries.

Therefore, different country practices the aspects differently so as to make a difference in their working which helps the other party to recognize the operational activities of each country individually. Thus, it is clear to look at the impact of these differences and how it affect international cross- border M&A.

2.4. The impact of culture and religion on the CG practices in the Gulf countries

The OECD highlighted some characteristics that can shape CG framework of any country (OECD, 2004). Alzeban and Sawan (2013) highlighted that more robust organizations have better board which translate into better-governed companies. He further ensured that corporations in the Gulf region must take the basic tenets of effective CG.

Although businesses in the Gulf region were safeguarded from financial crisis in 2008 that afflicted Europe, they are yet to adopt best practices of CG (Kumah et al., 2010). Consequently, businesses across the region still have a long way go in terms of developing Good CG as most Gulf institutions are still quite undeveloped due to market imperfections and failures as well as family ownership

(Saïdi, 2004). Moreover, most companies in the region are family-owned, hence creating a challenge in financial disclosure as they are indifferent to public scrutiny. Further to this, the level of disclosure and transparency was low in comparison with standards in Europe, North America, and Asia (Baydoun et al., 2012).

It is now commonly acknowledged that financial issues are not only consequence of weak CG, but also rather environmental, social and human damages are factors that might entail negative repercussion for soundness and sustainability (Donaldson and Preston, 1995). Baydoun et al. (2012) examined the impact of culture and religion on CG practices in MENA region including Gulf countries. Empirical evidence from the survey showed attitudes toward CG practices relies too heavily on religion and Muslims' beliefs which might present difficulties in practice. Thus, these Islamic religious beliefs specifically referred to as *Shariah* law have been widely used as a guiding principle in CG practices in countries such as in the Gulf region (Graiss and Pellegrini, 2006). Although some studies including Lim (2007) and Aras and Crowther (2009) have indicated that there is evidence of Anglo-Saxon and combined CG models principles applied in this region, yet there has been strong adoption of Islamic principles which guide CG implementation. Therefore, this has emerged to what is widely known as "Islamic CG." Perry (2011) stated that Islamic model of CG involves a "two-tiered board of directors (BOD)" one that is required by law and another required by religious law which is similar to the German corporation governance system. Therefore, this requires Islamic corporations to observe the laws of God and those created by man.

As a result, similar to Japanese, Chinese, Brazil and Indian context, CG models in Western countries, and other Continental Europe cannot be simply adopted in Gulf countries without taking into account the local unique factors such as religion and culture.

3. Methodology

The objectives of the study is to examine the actual *Shariah* CG practices of selected financial institutions from the banking and insurance sectors, which is focus on the variation and extent of the *Shariah* CG code compliances among Islamic companies in three Gulf countries (Saudi Arabia, Kuwait, and United Arab Emirate), and how it affect international cross-border M&A between Islamic companies in the Gulf countries and non-Islamic companies in the western countries. These countries are chosen, as they are the most active in the Islamic finance and relatively have the highest economic growth among the Gulf countries. They also represent vary degrees of orthodoxy in interpretation of Islamic laws. A qualitative research methodology was adopted, as it seeks to describe and the meaning of central theme in the subject matter as well as answer the research question.

A case study method was used to collect the data as it is believed to be appropriate to answer the research questions and it focuses on contemporary events. This research is also considered as an exploratory as it attempts to explore the variation and extent of the *Shariah* CG compliances among three Gulf countries and how it affects international cross-border M&A. The case study focuses on three Gulf countries as they are the most active in the Islamic finance.

In this study, semi-structured interview method was used to collect the data. The semi-structured interview method was adopted as it seeks to cover factual and meaning level, which can pursue in-depth information around the research questions and its faster compare to other methods such as questionnaires. The interview was conducted face to face as well as over the phone. The sample population was 40 respondents that are senior staffs and professionals (i.e., Lawyers, Managers, Islamic scholar, and experts) in the selected financial firms operating in compliance with *Shariah* principles. These respondents can provide in-depth and rich information because of their level of experiences and can make inference that can be generalized (Hair, 2007).

Each research participant group was interviewed on 20-26 questions about the impact of religion and culture on the formation of international cross-border M&As. The questions captured the existing practices followed in the cross-border alliances, CG policies, and the impact of Islamic principles on their work culture during his/her tenure at the company.

4. Result and Discussion

The disclosure of information whether it is related to the composition of BOD or the financial reporting, constitutes the key aspect of the CG. The implementation of these mechanisms in Islamic financial companies determines the success of the international cross-border M&A with non-Islamic companies in the west. The level of agreement with the terms and conditions relating to the composition of BOD and financial reporting can determine the success or failure of the international cross-border M&A. The study found that disclosure of the financial information to the shareholders and other stakeholders of the banking and insurance sectors are important and are obliged to disclose fairly.

This aspect of the disclosure is quite similar to conventional aspect regarding the disclosure of the financial reports and other related information to the stakeholders of the companies. However, some of the respondents from banking sector in Saudi banks did not agree with the above comments and reported that disclosure level of banks in Saudi is higher than the insurance sector as it does not always reveal all aspects of the operations of the company. There are some areas like the paying of an accurate *Zakat* (Islamic tax), which is the third pillar of Islam, is not fully disclosed to the stakeholders. This issue may put hurdles in the way of international M&A as the foreign companies operating in conventional sectors intend to reveal the information to stakeholders regarding every aspect of the company's operations.

From this work, it shows that among the Gulf countries, there are variations in the level of disclosure from different business sectors. For example, in Saudi Arabia and Kuwait, the level of disclosure from Islamic companies to the stakeholders is minimal and it varies among companies. While in the UAE, the level of disclosure from Islamic companies to stakeholder is higher and it seems unified. The variation can be attributed to how the *Shariah* board members in different companies disclose the information about *Zakat* and the *Riba* (interest) and this may affect where non-Islamic companies will like to invest. Most of the non-Islamic companies aim is to achieve higher transparency and disclosure of business activities to all the shareholders and stakeholders. This suggests that there is no clear policy, rules and regulation on how Islamic companies should disclose information rather it is based on interpretation. Thus, this may strongly affect the international cross-border M&A with non-Islamic financial institutions.

The adoption of *Shariah* law code is not deemed to have any negative impacts on international cross-border transactions because Islamic encourages expansion of business in a fair and honest manner (Abu-Tapanjeh, 2009). Therefore, the foreign companies that deal with companies from Muslim countries are deemed to deal with the Islamic companies "in a special way." This could mean that they are treated with the utmost care considering the complexities involved in applying the *Shariah* governance code that they have to deal with. It was found that Islamic principles of business do not prevent the expansion of business beyond the local boundaries. This was evidenced as a result of their business activities with other non-Muslim companies. This work found that one of the reasons why non-Islamic companies preferred the UAE's companies is their policies, rules and regulation regarding to level of disclosure and the interpretation of the *Zakat* and *Riba* principles.

Again, in Saudi Arabia and Kuwait, most of the Islamic companies are owned by family members and relations. The family members and relations make up the BOD, this affects the level of disclosure to an external agent. It also suggests that keyboard composition requirement on the level of experience and qualification is a key aspect of best CG practices and principles from both Islamic CG and the conventional CG. Thus, affect the level of interaction and the level of disclosure across the international cross-border M&A. However, in the UAE the compositions of the boards are mixed that came from different background and nationalities, even woman are allowed to be member of the BOD compare to Saudi Arabia and Kuwait, which is rare. This helped to provide the better experienced and qualified personnels in ensuring better disclosure of information and transparency of business activities in UAE. Thus, it may help to facilitate their international cross-border M&A. Therefore, with such variety non-Islamic companies may prefer flexible regulation than a rigid one.

Finally, another interesting finding obtained through interviewing with experts from banking and insurance sectors in the selected countries. The presence of *Shariah* boards in the Islamic banks

and insurance companies is remarkably different from the non-Islamic companies. Shariah principles provide the *Shariah* supervisory board as a unique and distinct feature between non-Islamic and Islamic financial companies (Farook et al., 2011). In recent years, due to the weak practices of CG, many Islamic financial companies have experienced failure due to the BOD collusion with the management (Grais and Pellegrini, 2006). The *Shariah* board runs in parallel with the BOD and influences the decisions of the directors in terms of making the international cross-border M&A and information to be disclosed to the external partners. The information regarding the *Zakat* and prohibited transaction is overseen by the members of *Shariah* board, and these are not fully transparent to the BOD and shareholders. Most of the respondents from the Saudi Arabia, the UAE, and the Kuwait companies participating in this study showed their agreement with the proposition that *Shariah* boards take introvert approach when it comes to disclosing the information about the real *Shariah* principles being applied to develop banking and insurance companies' financial instruments.

It was found that various companies globally are aware of Islamic principles and procedures and are committed to the application of Islamic principles. Furthermore, warnings about *Riba* were emphasized and they should stay clear of it. This was obtained as a result of their business engagement with non-Islamic companies. This shows that there are regulatory authorities in Saudi Arabia, which oversee the investments of the companies in the foreign countries and pass their verdict on the legitimacy of such transactions in the context of Islamic CG. However, emphasize was made that any transaction that is not in agreement with *Shariah* principles may affect the international cross-border M&A but suggested that there is need for a mediating company that understood the *Shariah* principles.

Some of the respondents from Saudi Arabia viewed Islamic CG, prevents the spread of local Islamic companies to international cross-border M&A, as they face many challenges in the non-Muslim world. For instance, *Riba* is not prohibited in the European countries, but Islam prohibits interest in business transactions, which shows that M&A activities can be affected by the religious principles. These views have been expressed by the most respondents.

Some respondents underline that corruption is founded in the *Shariah* supervisory board as some members collect bribe to allow some aspect of illegal procedures or transactions for some of the Islamic companies for their own gains. Thus, affect the principles of *Shariah* laws as well as having strong negative perception to non-Islamic companies. For this reason, it can easily affect international cross-border M&A principles and standards. Inspect the level of corruption, they emphasize that the Islamic *Shariah* boards are not willing to change the *Shariah* business principles. This can be a great barrier as most of the Muslim companies are not unwilling to change their business transactions when it comes to haram (impermissible) business transactions. The persistence on the religious values while making international M&A deals can be another barrier.

5. Conclusion

This study examined the actual *Shariah* CG practices of selected financial institutions (banking and insurance sectors), which focused on the variation and extent of the *Shariah* CG code compliances among Islamic companies in three Gulf countries (Saudi Arabia, Kuwait and United Arab Emirate), and how it affects international cross-border M&A between Islamic companies in the Gulf countries and non-Islamic companies in the western countries. To address the research questions the study looked at the various issues that were identified in the literature reviewed, which provided useful resources in shaping the semi-structured interview questions and the purpose of the research.

First, the study looked at what is CG by identifying various definition in the western region in contrast with the Islamic definition of CG were differences such as the Islamic principles were key in the definition. Second, the study presented Shariah CG and the impact of Shariah law on the practices and it was found that different country practice CG differently so as to make a difference in their working which helps the other parties to recognize the operational activities of each country individually. Third, the impact of culture and religion on the CG practices was presented in the literature review; it is found that there are variations in the adoption of Shariah principles in the three Gulf countries.

Finally, to answer the research questions, a semi-structured interview method was adopted with a sample population of 40. The result from the interviews shows that despite the strong religion and cultural ties between the Gulf countries states, there was diversity in the application of Islamic law within the selected countries. Emphases from the result show that *Zakat* and *Riba* are one of the most principles that may affect international cross-border M&A. Moreover, it was found that there is no clear policy, rules and regulation on how Islamic companies should disclose information rather it is based on interpretation, which may affect international cross-border M&A.

On the variations in the application of *Shariah* laws in different gulf countries, this is based on different interpretation of *Shariah* law by different scholars. This variation will affect the procedure on how other non-Islamic companies in international cross-border M&A should apply or understand the *Shariah* law of business. This might affect the integrity of *Shariah* law based on how the non-Islamic companies will view it. Also even the variation in some aspect of their procedure within the Gulf countries has posed more challenges on how to resolve some aspect of the procedures on the application of *Shariah* law that are not the same. For example, in Kuwait and Saudi Arabia, *Zakat* is an obligation for Islamic companies to pay each year compare to UAE which is not. Even when Islamic companies from Kuwait and Saudi Arabia merge, this will even result to double *Zakat* charges.

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