OECD Principles and the Islamic Perspective on Corporate Governance

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Abstract: This paper compares the OECD Principles and the Islamic perspective on corporate governance. The majority of countries in the world (including Pakistan) are using OECD principles as a benchmark for corporate governance in their corporate sector. Islamic finance and business practice have made significant progress in the last decade, but the issues of principles of corporate governance have not been investigated in detail. In this paper, OECD principles have been derived from the publications of the OECD. For the Islamic principles, the sources are the *Qur'ān*, *ḥadīth* and established *fiqh*. Following comparison, the paper finds that the OECD Principles cover six different issues and rights related to corporate practice, whereas Islamic corporate governance has a wider horizon, setting out obligations that extend beyond shareholders, financiers, suppliers, customers, and employees, and is concerned with the general well-being of humanity, not just temporal needs, and not just the Muslim community.

JEL Classification: G30; G38; G39.

I. Introduction

This paper explores the importance of Islam's principles of corporate governance in the light of *Qur'ān* and *Sunnah*, comparing them with the OECD (Organization of Economic Co-operation and Development) Principles. It looks at the implications for corporate governance from an Islamic perspective and considers the issues that raise for convergence in international standards of good practice.

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Corporate governance is basically about how a business should fulfill its responsibilities to shareholders and other stakeholders; it is founded on three essential principles, namely transparency, accountability and adequate disclosure. Corporate governance became a concern, with the increasing awareness of the importance of the need to protect the rights of all stakeholders, including minority shareholders, in the early twentieth century when corporations developed in Western countries. However, the concept was properly articulated only in the early 1990s with the Cadbury Report (1992). Subsequent reports continued to improve the Cadbury report, eventually taking shape as the *OECD Principles of Corporate Governance 2004*. These Principles were so sound that they were straightaway adopted by the EU, World Bank, USA and other OECD and non-OECD countries (Morck, 2005).

While as a term 'corporate governance' is relatively new, what it names is not unfamiliar in Islam. The hallmark of Islamic business ethics lies in the high values that underpin the business operations and transactions. Islam stresses the practice of justice and equality, truthfulness and transparency, and protection of minorities, accountability and adequate disclosure, just as it prohibits all forms of exploitation, in all walks of life, including business dealings: in Islamic law, there is no equivalent of the maxim 'buyer beware' (*caveat emptor*). The three underlying principles (transparency, accountability and adequate disclosure) of the OECD code, developed after a series of reports and researches, also underlie good practice in Islam, as known since the religion was consolidated 1400 years ago.

The effort in this paper in identifying the similarities and differences between the OECD Principles and the Islamic perspective to help in the definition of principles of corporate governance that are more widely applicable and acceptable in the world.

The paper is divided, following this introduction, into five sections: the need to identify and define good practice in corporate governance; an explanatory account of OECD principles; the Islamic perspective on corporate governance; comparison of the two approaches; and finally some concluding remarks are presented.

II. Corporate Governance

In the practical sense, corporate governance involves the nuts and bolts of how corporations should fulfill their responsibilities to their shareholders and other stakeholders. Corporate governance is the mechanism by which agency

problems of corporation stakeholders, including the shareholders, creditors, management, employees, consumers and the public at large are framed and sought to be resolved. Transparency, accountability and adequate disclosure are three essential ingredients in corporate governance (Hakim, 2002).

Good corporate governance reinforces sound regulation and supervision. It contributes towards maintaining market confidence, and strengthening transparency and accountability. Its emphasis is to be value-oriented and promote fairness and justice for all stakeholders of the organization. For it to work, good practices need to be embedded in all aspects of the organization's operations and at all levels of its personnel.

Good corporate governance is considered imperative for the competitive market: there is empirical evidence to suggest that countries that have implemented good corporate governance measures have generally experienced robust growth of corporate sectors and improved ability to attract capital compared to those that have not (SECP, 2004).

Such measures have become critical to worldwide efforts to stabilize and strengthen capital markets and protect investors (Darman, 2005). Good practices help companies to attract investment and improve their performance – to realize corporate objectives, protect shareholders rights and other requirements, and to be open to the wider public about how they are conducting their business. Research shows that investors from all over the world indicated that they would pay large premiums for companies with effective corporate governance. Companies with better corporate governance had higher per book ratios, confirming that investors do indeed reward good governance (McKinsey, 2004).

Put simply, corporate governance is the system by which companies are directed and controlled, which helps to focus the responsibilities of directors and managers for setting strategic aims and establishing financial and other policies. The mechanism of corporate governance include overseeing the implementation of policies and accounting to shareholders for the performance and activities of the company with the objective of enhancing its business performance and conformance with the laws, rules and practices of corporate governance.

III. OECD Principles of Corporate Governance

The *OECD Principles of Corporate Governance* were endorsed by OECD Ministers in 1999 and have since become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide.

They have advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non-OECD countries (OECD, 2004).

The Principles are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries. It provides guidance for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. The Principles focus on publicly traded companies, both financial and non-financial. However, to the extent that they are deemed applicable, they might also be a useful tool to improve corporate governance in non-traded companies, for example, privately held and state-owned enterprises. The Principles represent a common basis that OECD member countries consider essential for the development of good governance practices. They are intended to be concise, understandable and accessible to the international community. They are not intended to be substitutes for government, semi-government or private sector initiatives to develop more detailed 'best practice' codes.

> Corporate Governance is the system by which business corporations are directed and controlled. The corporate governance specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spell out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structures through which the company objectives are set, and the means of attaining those objectives and monitoring performance. (OECD, 2004)

The Principles of Corporate Governance designed by the OECD are as follows:

(i) *Ensuring the basis for an effective corporate governance framework:* The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

(ii) *The rights of shareholders and key ownership functions:* The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

(iii) *The equitable treatment of shareholders:* The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

(iv) *The role of stakeholders in corporate governance:* The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

(v) *Disclosure and transparency:* The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

(vi) *The responsibilities of the board:* The corporate governance framework should ensure the strategic guidance of the company, effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

The above six OECD principles of corporate governance are based on the following three basic principles:

(i) The mechanism of *decision-making* and its *transparency*
(ii) *Accountability* in roles and responsibilities
(iii) Adequate *disclosure* of results

The above principles seem to be clearly aligned with Hakim (2002) that transparency, accountability, and adequate disclosure are the basic ingredients of corporate governance. The soundness of these principles has been affirmed by their adoption all over the world (Morck, 2005).

IV. Islam and Corporate Governance

Islam strongly advocates all forms of positive governance. Islamic values expressed in ethical conduct are an integral part of the obligations laid upon the individual and the community. Rules of corporate governance derive from the underlying principle of assuring the economic well-being of the whole community on the basis of universal brotherhood, justice, mutual accountability, truthfulness and transparency, protection of minorities, adequate disclosure and equitable distribution of wealth. Islamic values have always advocated good corporate governance; the present challenge is to find

ways of assuring its application. The paramount rules are honesty and fair dealing, and the avoidance of exploitation: "Islam always encouraged trade and commerce as long as it is conducted within the framework of *Qur'ān*, and the word of Allah as revealed to His Prophet Muhammad" (Lewis, 2005).

Islam commands authority over the totality of a Muslim's being and behaviour, without any concession of special provision for 'sacred' and 'secular' domains. There are in particular, two dominant factors that shape the nature of Islamic corporate governance. The first is that Islamic Law, the *Sharīʿah*, claims sovereignty over all aspects of conduct, individual and collective, and to encompass civil as well as criminal jurisdiction. Its rulings define what is true, fair, just, the nature of corporate responsibilities, the priorities for society, along with some specific governance standards. The second factor is that, in addition to providing a set of business ethics, the law includes certain economic and financial principles (zakāt, prohibition of *ribā* and of speculation *etc.*) that have a direct bearing on corporate practices and policies. The three basic principles used by the OECD to define corporate governance can be located in Islamic ethics for business also.

4.1. Islamic corporate governance framework

The OECD emphasized the need for a proper corporate governance framework before stating the principles. In Islam likewise, we find overarching guidelines for the implementation and monitoring framework. Ibn Khaldun's analysis (1406) of the rise and fall of governments and civilizations, shows that moral norms (which, in a Muslim society derive from the *Sharīʿah*), may not be reflected in laws, and the laws may not be implemented effectively, if the political authority does not attend to the task seriously. It is the responsibility of the political authority to check morally objectionable behaviour (dishonesty, fraud and unfairness *etc.*) that is harmful for socio-economic development. The political authority must also ensure the fulfillment of contracts and respect of property rights, and instill in the people qualities that are necessary for social harmony and development with justice. In the Islamic perspective in particular it is not just the holding in check of objectionable behaviour (*al-nahy ʿan al-munkar*) but also the promotion of the desired behavior (*al-amr bi'l-maʿrūf*) through encouragement of an enabling environment for this purpose by means of effective educational, political, social, legal and economic reforms and the building of proper institutions. Government generally falls short in these tasks if it is not accountable to the people, affected by its decisions and

policies if it does not apply the law equally and equitably to all the different strata of society, and if it does not employ officers and agents on the basis of character and competence. Just as in the OECD principles, the underlying fundamentals emphasized in Islam are transparency, consistency and equality in exercising the law.

4.1.1. *Decision-making*

Besides the implementation framework, Islam is very clear on the principles of corporate governance:

> And consult them on affairs [of moment]. Then, when you have taken a decision, put your trust in Allah. (*Āl ʿImrān*, 3:159)
>
> Those who respond to their Lord, and establish regular prayers; who [conduct] their affairs by mutual consultation; who spend out of what We bestow on them for sustenance. (*al-Shūrā*, 42:38)
>
> Abū Ḥamzah Anas ibn Mālik (RA), who was the servant of God's Messenger (PBUH) reported that he said: None of you truly believes [in God and in His religion] until he loves for his brother what he loves for himself. (Reported in al-Bukhari and Muslim)

The above verses and the *ḥadīth* emphasize consultation with stakeholders at the time of decision-making and giving equal importance to all stakeholders (including minority shareholders). However, not found in the OECD principles is the keynote emphasis on trusting in God. There are two benefits of trusting in God after a decision has been taken. First, God's blessing will help in the implementation of the decision. Second, when all stakeholders have put their trust in God, there will be no conflict among them. The process of decision-making is also different from what the OECD envisages, in that Islam commends consultation and seeking consensus of stakeholders, whereas the OECD principles empower the Board of Directors and/or senior management to make the decisions.

4.1.2. *Disclosure and transparency*

The *Qur'ān*, in verses 282 and 283 of *Sūrah al-Baqarah*, makes an explicit and detailed requirement in respect of good practice:

> O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you... You should not become weary to write your contract down, whether large or small, for its fixed term, that is more just with God, more solid as evidence, and more convenient to prevent

> doubts among yourselves… Take witnesses whenever you enter into a commercial contract.
>
> And if you are traveling and cannot find a scribe, then let there be a mortgage taken… And do not conceal any evidence for whoever hides it, surely his heart is sinful, and God is Knower of what you do.

These two verses gave clear guidance for disclosure and transparency. The emphasis is on making records of each aspect of the transaction so that there is full, clear disclosure for all parties; thereby preventing misunderstanding and conflict. Again, something absent from the OECD principles is for the parties to be mindful that 'God is the Knower' of what they do and intend. If the concerned parties are indeed mindful of this reality, none will find the courage to hide something from each other. It will promote proper disclosure and transparency in recording and reporting the transaction.

4.1.3. *Accountability*

From the perspective of Islam, deeds are more important than mere words, slogans, rhetoric or lectures, as highlighted in various verses of the Quran:

> O ye who believe! Fulfill [all] obligations. (*al-Māʾidah*, 5:1)
>
> O ye who believe! Betray not the trust of Allah and the apostle, nor misappropriate knowingly things entrusted to you. (*al-Anfāl*, 8:27)
>
> O ye who believe! Eat not up your property among yourselves in vanities. But let there be amongst you traffic and trade by mutual goodwill, nor kill (or destroy) yourselves; for verily Allah hath been to your Most Merciful. (*al-Nisāʾ*, 4:29)
>
> And do not eat up your property among yourselves in vanities, nor use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of [other] people's property. (*al-Baqarah*, 2:188)
>
> Obey God, and obey the Apostle, and those charged with authority among you. If ye differ in anything among yourselves, refer it to God and His Apostle, if ye believe in God and the Last Day: That is the best and most suitable for final determination. (*al-Nisāʾ*, 4:59)

The *Qur'ānic* verses and Prophetic *aḥādīth* are clear principles commanding accountability in roles and responsibilities. The moral values needed are clearly set out in the *Qur'ān*, the *Sunnah* and *fiqh*. The *Qur'ān* requires the honest fulfillment of all contracts (5:1) irrespective of whether

these are written or oral, explicit or implicit; it prohibits the betrayal of trusts (8:27); it describes as sinful to derive any income by cheating, dishonesty or fraud (4:29). It forbids the giving of bribes to gain an improper advantage (2:188). The Prophet (*pbuh*) made it abundantly clear that whoever cheats is 'not one of us' (*i.e.* not a Muslim). He also said: "The hypocrite has three signs: when he speaks he tells lies; when he makes a promise he does not fulfill it; and, when he is entrusted with something he commits a breach of trust". And he said: "honest and trustworthy businessmen will be with the Prophets, the truthful ones and the martyrs on the Day of Judgment".

In Islam, the accountability in roles and responsibilities is not limited to business people only but applies to the whole of life. The rules for corporate governance therefore do not apply only to the Board of Directors (BOD), and senior management but also to every person connected to the organization. By contrast, OECD rules make senior management accountable to the BOD and the BOD to shareholders. Islam makes the responsible people accountable not only to stakeholders, but also to God – the Ultimate Authority. Again, the OECD rules make persons accountable for all written and defined obligations; Islam requires accountability of oral promises too.

V. Comparing Islamic Corporate Governance and the OECD Principles

We can now set out the comparison between corporate governance in Islam and OECD Principles in the form of a table, as follows:

Basis of Difference	OECD Principles	Islamic Principles
Authority	Directors have authority for decision-making. They follow the principles of OECD.	Sole authority belongs to Almighty God; all decisions are to be made by keeping in view *Sharīʿah*.
Decision-making	Decision-making rests with the CEO and senior management. Voting is required just for the selection of a BOD and few other decisions.	Consultation and consensus are required for every decision from concerned stakeholders.
Goal	Maximization of profits and shareholders' value.	Commitment to equity, fair distribution of wealth, and consideration for the whole community.
Accountability	Senior management accountable to shareholders.	Accountability not only to shareholders but also to God.
Ethics	Transparency, accountability and disclosure.	Justice, equity, truthfulness, transparency, protection of minorities, wider accountability, written as well as oral disclosure.
Application	Principles are not equally applicable all over the world.	Equally applicable all over the world.

VI. Conclusion

The OECD recommended a set of very effective corporate governance principles a decade ago and these principles have been efficiently implemented. The Islamic principles of good practice, in place for fourteen centuries, are very similar if not the same, but have not been efficiently implemented. The comparative study in the foregoing pages found that the OECD Principles cover six different issues and rights related to corporate governance, whereas the Islamic principles necessarily have a wider horizon, and place obligations beyond shareholders, financiers, suppliers, customers, and employees. They make reference to the well-being of humanity as a whole, not just material well-being and not just the Muslim community. Finally, the Islamic principles rest accountability ultimately on God, whose knowledge and authority are absolute.

Future research should both seek a formal statement of the Islamic principles of corporate governance and develop policies to enable and test efficient implementation of those principles.

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