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Corporate governance from the Islamic perspective: A comparative analysis with OECD principles

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Abstract

There is a growing concern emerged with a great profile regarding the Islamic principles of corporate governance. A major ethical component of any economic activity in Islam is to provide justice, honest and fairness and to ensure all parties their rights and dues. Islamic economy has progressed a great deal during these last two decades with impetus as an important concern in developing an Islamic corporate system. This paper is an attempt to discuss the nature, applications and comparison of Islamic principles of corporate governance (IPCG) with conventional principles of corporate governance considering special reference to Organization of Economic Co-operation and Development (OECD). After the discussion, it can be concluded that the dimension of Islamic perspectives of corporate governance has broader horizon and cannot compartmentalize the roles and responsibilities in which all actions and obligations fall under the jurisdiction of the divine law of Islam whereas, the OECD principles implements a firm with six different issue and obligations. Furthermore, this paper can provide some insight view in fettering mechanism to controlled, direct and organized economic activity from the Islamic point of view.

1. Introduction

The debate of corporate governance emerged as a great profile and of critical interest since the mid-1980s attracting a great deal of attention for the practitioners, communities

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as the managers, shareholders, investors, regulatory agencies, as well as in the academic research (Abu-Tapanjeh, 2006). The corporate governance is not only one of the main principle in running a firm successfully but also it ensures security confidence by monitoring and controls the operation of the firm. In this present business environment with diverse cultural background, the principles of corporate governance cannot be applied for all propositions. Thus need rigorously to adopt purposefully and implement new corporate rules and regulations that are more robust in the face of rapid financial innovation. This implies that good corporate governance is not just comply with hard and fast rules but also seen as guidelines for a supervisory framework of different environmental structures. Corporate governance need to become principle based, rather than being based on rules and regulations (OECD, 2004). This issue is well addressed by different committees around the world and has been repeated and renovated again and again by business committees and business leaders. These core concerns triggered in forming global reports on Corporate Governance. Hence, the Organization for Economic Co-operation and Development (OECD) principles endorsed by (OECD) ministers was born in 1999 and since then with its sound financial system became an international benchmark for policy makers, investors, corporations and other stakeholders.

The call for principles of corporate governance is not something new and alien to Islam. The Islamic financial system has thrived for centuries during the heyday of the Muslim civilization, but with the infiltration of modern conventional economy leads to misplace the Islamic civilization. And such a way Islamic economic developed as a social discipline in response to this environment. Although Islamic economy do perform mostly the same functions as conventional economy, there is always a distinct unique form of differences between both the principles implement. In fact, the primary feature of Islamic economy is to give just, honest, fair and balanced society as envisioned to Islamic ethical values and rules. (Ahmad, 2000; Mirakhor, 2000; Warde, 2000), expressed that Islamic business is always characterized by ethical norms and social commitments, grounded on ethical and moral framework of the *Shariah*. (Asyraf, 2006) herewith underpinned nicely that these *Shariah* injunctions interweave Islamic financial transactions with genuine concern for ethically and socially responsible activities at the same time as prohibiting involvement in illegal activities or those which are detrimental to social and environmental well-being. Khalifa (2003) also describes Islamic economics as it is Godly, ethical, humanly, and moderate and balanced. Therefore, all forms of exploitation are prohibited in Islamic business system and should underpin with the ethical rules of *Shariah*.

The main objectives of this study are to briefly discuss the current state of corporate governance practices at the conventional economy and to establish the measurement of good corporate governance at the functional level and how far this approach can ensure the relativity with the Islamic corporate governance. This study describes a radically different approach focusing the similarities and differences of conventional corporate governance from the Islamic perspective. The researcher referred the principles of corporate governance (OCED)—2004, for the purpose of this study. It is done so, since these principles were so sound that it was immediately adopted by many well profounded companies and organizations and soon became a benchmark for identification of good elements all over the world.

Therefore, this paper is an attempt to bring a comparative position and to analyze the similarities and differentiations of the revised OECD principles and its annotations to the Islamic perspective.

The remainder of the paper presents into six divided sections, the following section discusses the identification of corporate governance. The OECD principles are further analyzed in section three. Section 4 discusses the Islamic perspective of corporate governance and its comparison with OECD principles and the last section gives the conclusion of the study.

2. Corporate governance

Corporate governance characteristics albeit playing different roles in ensuring companies success are ultimately the only responsible role affecting the business economy. (Van Den Berghe, 2001), state that performance is finally the outcome of many interlinking factors where corporate governance is the only one possible element within the whole set of performance drivers.

In fact, the term "corporate governance" has gained prominence only during the last two decades (Zingales, 1997). This terminology clearly had its origin from a Greek word "kyberman" which means to steer, guide or govern. This passed on from Greek to Latin word as gubernare and the old French "governer", but this word has been defined in different ways by different organizations or committees, according to their own ideological concerns. The OECD has defined it as the "set of relationships between a company's management, its board, its stakeholders and other stakeholders" (OECD, 1999). Mr. Wolfensohn (Wolfensohn, 2001), World Bank President, has gone a step further by explaining that corporate governance needs to be "fairness, transparency and accountability". Dyck (2000) also describe in adding this argument that corporate governance is broadly the complex set of socially defined constraints that effect the willingness to make investments in corporations in exchange for promises. Furthermore, Dalton et al. (2003) argued that agency theory is the theoretical basis of most of the research on corporate governance, they suggest the need to consider other theoretical ways of examining the relationship and propose a substitution theory approach which considers a range of governance mechanisms. Here it would be worth noting to quote Hakim (2002); he explains corporate governance as, "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". Hence, therefore, it can be concluded here that corporate governance is a set of mechanism that helps in confirming, with fair and just dealing to all the stakeholders and to strengthening transparency and accounting.

Good corporate governance has long been considered a crucial role for stakeholders in the business environment. Though the goal of corporate governance differs from one firm to another, or from one country to another, the main important concern is to impetus a good code of mechanisms to uplift and govern the organization. But with the current business pressure, corporate governance structure changes very fast. The financial innovation and globalization forcing the executives to adopt rigorous re-evaluation of corporate governance principles. Meyer (2004) says that a systematic governance means adjusting the signals with an organization such that staff automatically do the right things, without the need for oversight. Sound corporate governance practices have become critical to worldwide efforts to stabilize and strengthen good capital markets and protect investors (Darman, 2005).

Many studies exist linking good corporate governance with better performance. There is empirical evidence to suggest that countries that have implemented good corporate governance measures have generally experienced robust growth of corporate sectors and higher ability to attract capital than those that have not (SECP, 2005). Fianna and Grant (2005) explains that good corporate governance helps to bridge the gap between the interests of those that a company, by increasing investor confidence and lowering the cost of capital for the company. Furthermore, they also add that it also helps in ensuring company honors, its legal commitments and forms value-creating relations with stakeholders. Coles et al. (2001) and Durnev and Han (2002), also found that companies with better corporate governance enjoy higher valuation. However, there is a growing argument that corporate governance still needs to be renovated and revised. Hence, it can be concluded that issue of good corporate governance is still open for discussion.

3. OECD principles of corporate governance

Supranational authorities like the world bank developed their own sets of standard principles and recommendations. Likewise, OECD principles, a notable global report on corporate governance set its own principles consulting with governments and stakeholders from different countries and committees worldwide. It is considered one of the principles of the twelve key standards for sound financial systems adopted by the Financial Stability Forum (FSF).

The OECD Principles of corporate governance originally adopted by the 30 member countries of the OECD in 1999 have became a reference tool for policy makers, corporations, institutional and regulatory frameworks and others. It also provides practical guidance and suggestions for stock exchange, investors, corporations and other profound organizations of the world other than OECD member countries. Daniel (2003) states the reasons why one should care about the quality of corporate governance, as firstly, it leads to increased economic efficiency and growth, it improves the use of capital, and encourages foreign direct investment. Secondly, it lowers the risk of crisis and in the case of an external shock it improves the robustness of the economy. Thirdly, it is crucial for the legitimacy of a market economy. Henceforth, to ensure consideration of these standards, the OECD has oriented discussions including some main categories of the principles. The OECD began a review of the principles in 2003 considering the recent changes and developments and after an extensive review the process led to adopt revised and reviewed OECD principles of corporate governance in April, 2004. The revision principles not only reflect the experience of OECD countries but also the emerging and developing economics. The revised principles are non-binding in nature and it lays up to the governments and market participants to decide for their own framework. It also confirmed the adaptability of the principles as a reference in varying legal, economic and cultural contexts. “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 following are the main areas of the OECD principles and its annotation:

Principle 1: *Ensuring the basis for an effective corporate governance framework.*
Annotation: 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.
Principle 2: *The right of shareholders and key ownership functions.*
Annotation: The corporate governance framework should protect and facilitate the exercise of shareholders' rights.
Principle 3: *The equitable treatment of shareholders.*
Annotation: The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunities to obtain effective redress for violation of their rights.
Principle 4: *The role of stakeholders in corporate governance.*
Annotation: 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.
Principle 5: *Disclosure and transparency.*
Annotation: 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.
Principle 6: *The responsibilities of the board.*
Annotation: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and board's accountability to the company and the shareholders.

The main theme of the above principle lies in four basic principles. Firstly, the mechanism of business ethics, secondly the mechanism of decision making, thirdly in adequate disclosure and transparency and lastly the mechanism of book keeping and final accounts.These OECD principles are so sound that even the non-members of OECD are implementing and adopting. As Morck (2005) states that the soundness of these principles has been proved by its adoption all over the world the next section will discuss the Islamic view of corporate government from the Islamic perspective.

4. Corporate principles from Islamic perspective

4.1. Islamic business principles

The Islamic religion relates directly to all spheres of life, including how to conduct the trade and commerce. *Shariah* covers not only religious ritual, but also many aspects of day-to-day life, politics, economics, banking, business or contract law, and social issues (Wikipedia, 2005).

Muslims are directed to conduct their business in accordance with the *Shariah* rules, i.e., to be fair, honest and just toward others. Accumulating wealth of oneself is allowed under the constraint restrictions of Islamic ethics. Saeed (1996) explains that, "wealth is considered a trust and a test, where failure to use it wisely, especially to alleviate the hardship of the poor is detrimental to the person who holds that wealth". And above all, the main virtue is of prohibition of *riba*. Haqqi (1999) states that one of the most important prohibitions against misuse, of wealth is prohibition against *riba*, which is generally translated to mean "usury" or interest. This statement impetes that the virtue of Islamic business is fair, and honest dealing, where all kinds of exploitations are prohibited. Lewis (2005) rightly points out here that, "Islam always encouraged trade and commerce as long as it is conducted within the framework of Holy Quran, and the word of Allah as revealed to his prophet Muhammad (PBUH).

Business transactions had long been in practice since the early days of Islam, but with the colonization of the western countries, the social environmental discipline gets inflicted (infected) with the western ideology. Sequently, Islamic economics developed as a social disciples in response to this environment, with the aim of establishing or restoring Islamic authority in areas where Muslims increasingly were falling under the sway of western ideas (Ahmad, 1984; Kuran, 1995; Nasr, 1984). Business needs to be arranged and organized in order to contest the outcome. Lewis (2005) explains that, how firms are organized, directed and controlled, in short what is now called corporate governance, is one aspect of this broader agenda. Yet, despite a considerable interest in the topic of corporate governance recently by organizations such as the Islamic Development Bank (Ahmad, 2000; AAOIFI, 2003; Chapra, 1992), little is written on corporate governance structures and there is not even as yet a unified expression in Arabic to represent the meaning of corporate governance (Sourial, 2004). Albeit this statement, corporate governance in Islamic law provides and embodies a more larger and vast guidelines with encompassing duties and practices as on how to deal with economic transactions up to the moral conduct of a Muslim without even defining the modern world corporate governance as such Islamic laws impetus corporate governance in every individual actions of Muslim up to the social environment. Hence, the following is a discussion as how the OECD principle of corporate governance can be seen in Islamic business activities by taking these following principles and how it governs the conduct of business.

4.1.1. Business ethics

In Islam, the absolute and eternal owner of everything on earth and on the heaven, belongs to Allah (S.W.T.), the almighty, and we human beings are just vice regent of it. Muslims are entitled to conduct their business activity as guided by the *Shariah* code of conduct, which encourage to be just, fair and honest to all the people involved in the business. Therefore, a Muslim business people are hence taught to possess a high moral conduct, so not to betray, deceive or exploit his fellowships. Muslim should also not therefore overcome with there business activity with a consequent results in profit making only. At the same time, Muslims require to work and produce and being not to be lazy and unproductive. Thus, Ali (2005) explains "the Islamic work ethic, as work is a virtue in light of a person's needs, and is a necessity for establishing equilibrium in one's individual and social life (Nasr, 1984). This is mentioned in the Holy Quran (6.132): "To all are degrees (or ranks) according to their deeds". This clearly shows that any system without an appropriate ethical and moral climate, will not influence a proper system of governance. Therefore, like OECD, the above discussion clearly emphasized that Islamic business ethics promotes transparency, consistent of and equal rule of law.

4.1.2. Decision-making

The holy Quran clearly mandates the principles, which govern the Muslims' lives. These principles were implied and compiled to Muslim since the early days of the Islamic state. The ethical notion of corporate governance assumes a more broader and holistic significance in Islam. The dimension of governance in all manifestations is essentially about decision-making. Islamic ethics of decision making not only comply in the hands of superior officials but also extends the responsibility to fulfill with obligations beyond shareholders, clients, financiers, suppliers, customers, employees, embracing within spiritual religious bounty. An employee would be expected to contribute his or her knowledge to the formulation and implementation of the organizational vision and consultative procedures should be applied to all affected, i.e., shareholders, suppliers, customers, workers and the community (Baydoun et al., 1999).

Islam mandates human beings as trustees of Allah in all situations and the ultimate trust is to keep in Allah, the ultimate owner of everything in this world. Muslims are taught to maintain and strengthen good relationship with superiors, clients and the management conforming with the divine norms and rules, hence inspired the whole community with values of truthfulness, fairness, tolerance and justice, etc., this shows that the Islamic institutions imply decision-making in a different and more broader ways than conventional institutions do. This is written in many verses of the Holy Quran and Hadith.

"And consult them on affairs (of moment). Then, when thou has taken a decision, put thy trust in Allah" (Al-Imran 3.159).

"Those who respond to their Lord and establish regular prayer; who conduct their affairs by mutual consultation; who spend out of what we bestow on them for sustenance" (Ash-Shura, 42.38).

Abu-Hamzah Anas bin Malik (RA) reported that the prophet believers (in Allah and in his religion) until he loves for his brother what he loves for himself (Al-Bukhari & Muslims). Islam introduced improvements in accordance with the moral principles enunciated by the Holy Quran (Stork, 1999).

These above verses clearly emphasize on consultation and whom to consult. The best benefited ways to whom to consult are those good men who respond to God and fear God, and who can conduct fair mutual justice with equal importance to all. Thus, this conveys the Muslims to "live true in mutual consultation and forbearance, and rely on Allah. Islam encourages the participants to work together freely and frankly when arriving at decisions (Shaikh, 1988). Islam also demands the whole group to participate in decision-making.

Another Islamic principles that represent a core element of corporate governance is that of an institution called Hisbah established under the Abbasides (750 A.D. onwards) which ensures compliance with the *Shariah* requirements, particularly in the business affairs. Duties like correcting weight and measures, fair trading rules, checking business, frauds, auditing illegal contracts, keeping the market free, and preventing hoarding of necessities were carried out by this office as stated by (Abdul Rahman, 1998).

Therefore, since the early days of Islam, corporate governance is embedded in an appropriate ethical environment fulfilling the bounty of *Shariah*. The mode of corporate governance is hence more vast and bigger in dealing with that of the OECD principles, where BOD and the senior manger are entitled to implement the decision-making.

4.1.3. Disclosure and transparency

In Islamic economy, accountability is entitled to produce a true and fair disclosure and transparency. Accountability is first of all to Allah. The fundamental concept of Islamic accountability is believed that all resources are made available to individuals in a form of trust. Hence true disclosure of financial facts, and accurate information should freely available to the users. Another important point involved in disclosure is to provide the users adequate information which needed for sound financial decisions. This will lead in paying accurate *Zakah* which is the third pillar of Islam. Accuracy in a sense, involves an aspect of fairness and just system. This can help in making economic and business decisions consistent. This fundamental is a powerful ethics in Islamic accounting system and helps in promoting proper disclosure and transparency in any business dealing.

4.1.4. Book keeping and final account

Islam encourages to deal business ensuring fair and just financial transaction between each other and the ultimate accountability to Allah. Al-Quran clearly shows us the moral ethics of dealing this principle, as

"O you who believe! when you deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing and let a scribe write down faithfully as between the parties" (Al-Quran, 2.282).

"And if you are traveling and cannot find a scribe, then there be a mortage taken. . .. . And do not conceal any evidence for the whoever hides it, surely his heart is sinful, and Allah is all knower of what you do" (Al-Quran, 2.283).

"We shall set up justice scales for the day of judgment, not a soul will be dealt unjustly in the least and if there be (no more than) the weight of mustard seed, we will bring it (to account), and enough are we to take account" (Al-Quran, 21.47).

These verses clearly mandate that transactions in any business dealing should be written down by a good man who possesses high moral conduct and can be just fair to each party.

Further, it also shows again that business should deal in a fair, honest and just manner. Assets should not be usurped and should be earned in a lawful way where the economic benefits go to its owners. Therefore, any financial transaction should be determined to the balanced sheets and thus any unlawful possessions of assets are prohibited. Acquiring wealth in unlawful means will only lead to widespread inequalities and social waste. Islamic law has very clear view on the basic principles as to how financial reporting and accounting practice should be undertaken in terms of objectives based on the spirit of Islam and its teaching (Lewis, 2001a, 2001b).

Allah knows everything and whoever hides, has his own account on the day of judgment. This shows that justice and balance has profound implication for the conduct of Islamic business, and thus provide general approval and guidelines for lawful records of any business transaction in a very well organized system.

From the above discussions, Islamic business policies and relevant business and commercial affairs should conduct in a fair, just and honest manner. Khalifa (2003) states that the distinctive characteristics of Islamic economics are that it is godly, ethical, humanly and moderate and balanced. Islamic business since historical time requires an honest fulfillment. The institution of Hisba offers a framework of social ethics, relevant to monitor the corporation, with the objective to obligate the correct ethical behavior in the wider social context and empower individual Muslims to act as private prosecutors in the cause of better governance by giving them a platform for social action (Lewis, 2006). Islamic moral ethics also consider that those whoever cheats is not one of them and cheating is considered as a moral problem, which needs greater internal fortitude to overcome it, while conventional economy believes in defiency of external law enforcement or of bad corporate governance. Therefore, it clearly clarifies that accountability and responsibility are trusted to God, the ultimate authority. In Islam, dealing with corporate governance is not only just the designation or his position and power but also his internal moral enthusiasm to fulfill and carry out the conduct of the job within the bounty of Islamic *Shariah*. It can be also seen that the responsibility are not entitled to those only who encompass the business power but also to all those stakeholders who are involved and related with the organization. Corporate governance in OECD entitled the power of decision making and participation of deeper internal business dealings to those limited persons holding higher designation as BOD and senior management authorities whereas, in Islam, those whoever related stakeholders of the organization are given full rights and responsibility to participate and conveys their thoughts and ideas in reforming better corporate governance. And above all Islam was made accountable not only to stakeholders, but also to God, the ultimate owner and authority. These powerful moral ethics help in promoting fair, just and honest business dealing.

5. Comparison of Islamic Corporate Governance Principles with OECD principles

An attempt is made to bring a comparative position of Islamic principles of corporate governance with the revised principles of OECD.

Principle number	OECD principles and annotation	Islamic principles
	Insuring the basis for an effective corporate governance framework	
1	• Promotion of transparent and efficient markets with rule of law and division of responsibilities	• Promotion of business within ethical framework of *Shariah* • Believes in profit and loss • Primacy of Justice and social welfare with social and spiritual obligations • Prohibition of interest

Principle number	OECD principles and annotation	Islamic principles
	The rights of shareholders and key ownership functions	
2	• Basic shareholder rights	• Property as trust from God
	• Participation in Decision-making at the general meetings	• Sole Authority is God
	• Structures and arrangements markets for corporate control	• Society as stakeholders
	• Ownership rights by all shareholders including institutional shareholders	• Accountability not only to stakeholders but also to God, the ultimate owner
	• Consultative process between shareholders and institutional shareholders	
	The equitable treatment of shareholders	
3	• Protection to minority and foreign shareholders	• Just and fairness of value
		• Equitable distribution of wealth to all stakeholders and disadvantages members in the form of *Zakat* and *Sadqa*
		• Social and individual welfare with both spiritual and moral obligation
		• Sensation of Equality
	The role of stakeholders in corporate governance	
4	• In creating wealth, jobs and sustainability of financially sound enterprises	• Islamic accountability to *Falah* and social welfare orientation
		• Haram/Halal dichotomy in transaction
		• Social & individual welfare from both spiritual and material
		• Consideration to whole community.
	Disclosure and transparency	
5	• Matters regarding corporation	• Accountability with *Shariah* compliance
	• Financial situation	• Socio-economic objectives related to firms' control and accountability to all its stakeholders
	• Performance, ownership and governance	• Justice, equality, truthfulness transparency
		• Wider accountability with written as well as oral disclosure
	The responsibilities of the board	
6	• Strategic guidance	• Accountability not only to company or board or stakeholders but also to Allah the ultimate authority who leads to welfare and success
	• Monitoring of management	• Holistic and integrative guidance
	• Accountability to company and stakeholders	• Negotiation and co-operation
		• Consultation and consensus seeking for each decision with related stakeholders

6. Conclusion

This study has aimed to analyze the possible need of corporate governance from Islamic perspective with the world notable principles reviewed by OECD. It discusses above the current state of corporate governance practices at the conventional economy and established the measurement of good corporate governance at the functional level, compared from Islamic perspectives. Like any other civilization and religion, Islamic culture also embedded a good corporate governance since the early days of Islamization. Islamic society had its own different views and values compared with the outer non-Islamic world. The strong belief of accountability in this world and thereafter had strong implication in every Muslim life and governs a wider scope and extended obligations of corporate governance with that compared to conventional principles. Hence success and welfare is measured with moral and ethical spiritual obligations with a strong trust in accountability with Allah, the ultimate authority.

Therefore, the recommended set of principles of OECD had long been existing since the early stage of Islamic civilization. But, with the globalization tendency and in filtering with the cultural, religious and social, business and political factors, lead to misplace the true ethos of Islamic civilization. Hence, in this present situation, the OECD principles have been successfully implemented and considered a very effective tool of corporate governance as compared to Islamic principles of corporate governance.

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