

## ISLAMIC WORK ETHICS AS AN ADDITIONAL CHARACTERISTIC OF INTERNAL CORPORATE GOVERNANCE MECHANISMS

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**Abstract:** *The separation of ownership and management has resulted in conflict of interests between the owners (principals) and managers (Agents). To mitigate this problem of agency, corporate governance mechanisms has been introduced. Corporate Governance Mechanisms (CGMs) aims at constraining managers from adopting self-interest behavior. However, financial scams and scandals resulting from this behavior are still seen worldwide. This paper attempts to discuss the failure of CGMs in preventing financial scams and frauds, and the importance of characterizing these mechanisms by Islamic Work Ethics (IWEs). This research uses qualitative approach through reviewing the literature to gain broad insight of the issues related to Corporate Governance (CG) and IWEs. The findings show that IWEs can provide a protection shield to CGMs against any misconduct or corporate crime. The study urges regulators to stop limiting their focus on merely technical CGMs characteristics such as size, independence...etc. IWEs can provide a clear explanation why financial scandals and frauds occur in Islamic institutions that have CGMs technically meeting the requirements of the laws and regulations, while not characterized by IWEs.*

**Keywords:** *Islamic Work Ethics, Corporate Governance Mechanisms, Financial Scandals*

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## Introduction

The separation of ownership and management has resulted in conflict of interests between the owners (principals) and managers (Agents). Jensen & Meckling (1976) assumed that agency relations emerge when one or more principals pay an agent to act on behalf, providing the agent with prescribed control and delegated authority to make decisions. It is argued that this separation between control and ownership creates agency problems, resulting in managers (agents) adopting an opportunistic behaviour that benefits themselves at the expense of others throughout their diligence over the shareholders (principals) (Fama and Jensen, 1983). This materialistic view seems to be true in the absence of ethics and religion forbidding such a behaviour benefiting oneself while harming others in the society.

However, previous studies argue that corporate governance mechanisms seem to be failing the combat against fraud and financial collapses caused by unethical behaviour (Saadeh et al., 2016). According to Al-Delawi (2019) the Enron collapse showed that such financial scandals can be symptoms of deep problems and a result of absence of ethical standards. This is supported by Thabit and Solaimanzadah (2018) who stated that the financial scandals are signal of insufficiency and failure of reporting mechanisms, financial management, and audit quality. It can be claimed that characterizing CGMs by technical aspects do not accommodate these mechanisms against unethical behaviour Al-Kmishy (2018) indicates that ethical behaviour based on Akedah and closeness to Allah SWT directs individuals to be away from unethical behaviour causing such frauds and scandals. Additionally, Al-Delawi (2019) argued that the integration of religion and morality with ethics in professions like accounting may enhance its professional services quality. Moreover, it was suggested that religion has the potential to influence corporate governance and impact companies' demand for quality audit services (Hu et al., 2019). This paper attempts to discuss the failure of CGMs in preventing financial scams and frauds caused by unethical behaviour. Also, it aims to show the importance of characterizing CGMs by IWEs.

## Literature Review

Many studies argued that these financial scandals and collapses were due to unethical behaviour (Czerny, 2020). It is stated that the collapses of many worldwide companies like Enron was mainly caused by the weakness of corporate governance mechanisms and the cheating culture that fed conflict of interest to a large extent, in addition to the unethical behaviour by board of directors, chief executive officer, internal auditor, and external auditor (Cuong, 2011). Thus, it can be argued that depending on merely organisational characteristics of corporate governance mechanisms such as size, meetings, independence...etc does not guarantee full protection against financial scam and scandals. Companies also should pay attention to ethics of those assigned with corporate governance responsibilities. Al-Kmishy (2018) agrees with this view and stated that ethical behaviour based on Akidah and closeness to Allah SWT directs individuals to be away from cheating behaviour causing financial scams and scandals. Religion influence companies' decisions by affecting their decision-makers' behavior. Through its doctrine, a religion through its doctrine could invisibly affect its followers' perspective to altruism, risk avoidance, and self-discipline (Hu et al., 2019).

### The Demand for Corporate Governance Mechanisms

According to agency theory, the separation of ownership and management has created a potential conflict of interests between the owners (principals) and managers (Agents) (Watts and Zimmerman, 1986). According to Jensen & Meckling, (1976) this conflict of interest leads each party to adopt an opportunistic behaviour driven by self-interest. Fama and Jensen (1983)

stated that there must be governance mechanisms to mitigate conflict of interest causing agency costs.

In this context, the demand for corporate governance mechanisms has come as an appropriate solution to overcome the causes of financial collapses and trust crises of users in the financial statements (Al-Jamhoudi, 2019). According to Zain and Subramaniam (2007) the purpose behind corporate governance mechanisms is to investigate and assess the level of monitoring and control procedures in organisations.

### **The Role of Unethical Behaviour in Corporate Governance Mechanisms' Failure**

Financial scams and companies' collapses has been due to unethical practices, which made many countries throughout the world seek to adopt control system presented in corporate governance mechanisms (Malah & Wa'am, 2019). However, unethical behaviour may not be mitigated by these mechanisms. Literature shows evidence of the weakness of governance mechanisms that are not characterised by religious ethics, in overcoming the problem of corruption and fraud. For example, Faber (2005) investigated the relationship existing between corporate governance quality and reliability of financial statements, in a sample of organizations suffering from fraud and financial misstatements. In addition, other studies have proved the failure of corporate governance mechanisms in overcoming the increasing cases of financial collapses and fraud in many countries. For instance, in France, Societe Generale bank was a case of fraud committed by an employee who managed to defraud the bank with approximately 7.4 billion dollar (Gauthier & Mollenkam, 2008). In addition, in 2010 the BBC has carried out a survey in cooperation with the Association of Certified Fraud Examiners (ACFE) and they found that the world has been more corrupt than it was used to be three years ago (BBC Arabic.com, 2010).

### **The Role of Unethical Behaviour In External Audit Failure**

The failure of corporate governance mechanisms in preventing fraud and financial scams has been accompanied with the failure of external audit. According to Verschor (2014), external audit firms are seeking to obtain more revenue rather than providing audit services branded by quality. Audit firms, for the sake of maximizing revenues, has extended their work with audited companies by providing administrative and consulting services.

These cases of collapses led to investors losing trust in financial statements, even those audited by large audit firms (Al-Kmishy, 2018). According to Köhler and Quick (2018), cases of financial collapses raised doubts about the quality of external audit services and corporate governance mechanisms. The collapse of "Enron" and the later collapse of the "Anderson" can be a good example on the collapses that resulted in trust crisis among financial statements users in both corporate governance and external audit (Khalifah, 2018). According to Cuong (2011) the collapses of many worldwide companies like Enron was mainly caused by the weakness of corporate governance mechanisms and the cheating culture that fed conflict of interest to a large extent, in addition to the unethical behaviour by board of directors, chief executive officer, internal auditor, and external auditor.

Previous studies argue that corporate governance mechanisms seem to be failing the combat against fraud and financial collapses caused by unethical behaviour (Saadeh et al., 2016). Characterizing CGMs by technical aspects do not fully accommodate these mechanisms against unethical behaviour. Al-Kmishy (2018) indicates that ethical behaviour based on Akedah and

closeness to Allah SWT directs individuals to be away from unethical behaviour causing such frauds and scandals. This emphasises the importance for corporate governance mechanisms to be characterised by ethics that shape ethical behaviour for those assigned with corporate governance duties, thus mitigating the consequences of the adoption of unethical behaviour.

#### Methodology

This study uses secondary data to provide an understanding of corporate governance mechanisms, and to identify its failure in combating financial fraud. Also, to cast the light on the role of Islamic work ethics in shaping a Muslim’s managerial behaviour, and hence the importance of characterizing corporate governance mechanisms with Islamic work ethics instead of relying on conventional codes of ethics. Islamic ethics differs from the conventional code of ethics as it is rooted in Islamic Shariah. Therefore, secondary data were collected through a literature review related to corporate governance, and Islamic work ethics that are rooted in Shariah, such as Al-Qur’an and Al-Hadith by the Prophet Mohamed SAW. Thus, the Islamic work ethics as a solution to the failure of corporate governance can be analysed.

#### Results And Discussion

The scenarios, from thousands of cases and irregularities, have demonstrated that rules and regulations can no longer be considered as a shield of protection for stakeholders (Salin et al., 2017). In addition, It was argued by Schwartz et al. (2005) that the business community now should emphasise on the importance of ethical obligations more than the regulations’ obligations. businesses should cease the dependence on rules and regulations. Furthermore, they argued that Revision and introduction of new laws and guidelines appears to be an unsuccessful effort to eliminate all the scandals and corporate crimes. The difference between Islamic Work Ethics and conventional codes of conducts is summarized in the table 1:

**Table 1: The Difference Between Islamic Work Ethics and Conventional Codes of Conducts.**

Comparison Aspects	Islamic Ethics	Conventional Codes of Conduct
Source	Quran and Sunnah	Professional academics
Evidence	To you, your religion for me my religion," "and this is my straight path so follow it" "I was sent to complete good morals.”	Standards of professional conduct
The Reason Behind Its Compliance	That Allah is Hearing, Knowing, and that God has power over all things.	Following professional rules to gain the community’s acceptance.
Extent Of Compliance	Part of the Islamic faith, pleasing Allah. Worship reflects in ethics and ethics reflects in worship.	Behaving morally right at work
Purpose	To obtain Allah’s pleasure	To obtain international organization for standardization (IOS)
Monitored By	Allah SWT, prophet, and believers	Members of profession

<b>Penalties For Violators</b>	Whether fraud is discovered or not, in this world cheater is not one of us, and is a hypocrite and In the Hereafter he is excluded from the basin Messenger of Allah PBOH	Cheater will be Physically punished. But in case fraud is not discovered there won't be any penalty
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Source: Developed by Authors

The religious standpoints in solving the moral issues have always been ignored by previous empirical studies. In fact, religion can constitute a good mechanism to solve business matters. However, most previous studies only focused on the Protestant work ethic that was rooted from Max Weber and experience in Western countries. This viewpoint has some limitations, since it was based on capitalism, where profit maximisation is the main driver and motivation for business transactions of the company (Salin et al., 2017). This study overcome this problem by placing an emphasis on Islamic work ethics of mechanisms responsible for monitoring and controlling business transactions, rather than relying on rules and regulations.

Islamic religion is a comprehensive way of life that directs it followers to be obedient to Allah SWT in all life matters including work. Shariah “the Islamic rules” is primarily based on are the Qur’an and Sunnah (Kamaluddin, 2010). The Qur’an is revelations of Allah SWT to his Prophet Muhammad (Peace Be Upon Him), which comprises of all basic rules, regulations and principles covering all human deeds. The Sunnah Indicates the Prophet’s life that explains the way of life and behaviour as commanded by Allah SWT as prescribed in AL-Qur’an.

### **The Distinction of Islamic Work Ethics Over Conventional Ethics**

Ethics in Islam is like those of ethical systems as they all distinguish between right and wrong (Mohammad & Quoquab, 2016). However, Islamic ethics is different from conventional codes of ethics in several aspects. First, Islamic Shariah does not apply the principle of “the end justifies the means” that is largely applied by contemporary ethical systems based on teleological approaches. In fact, teleology places an emphasis on the results and consequences for decision making. While it ignores the harmful consequences of the decision when it impacts the minorities. Under this principle, for example, it is a morally acceptable for controlling stockholders decide to delist a firm from stock market to become private firm without paying sufficient compensation to minority shareholders.

Second, Islamic ethics also oppose ethics based on deontological approaches, which emphasise the motivation and the principal of ethical decision-making. According to deontology-based ethics, the results of a decision are deemed less important compared to teleology-based ethics. In effect, deontological ethics are broadly criticized for their limitations in recognizing the decision’s final outcomes. More clearly, individuals in work cannot simply make a decision and not consider the consequences of the decision taken. According to deontological ethics the decision-maker just make a decision depending on merely what he or she considers as right, and he or she does not need to assess the results of the decision taken whether a success or failure. For example, according to deontological ethics, it is considered moral for managers to invest in high risky projects since they believe it is the right thing to maximize the revenues, but at the same time managers do not pay attention to the outcome of their decision which may result in huge loses to the company (Salin et al., 2017).

In this context, weaknesses of ethics based on teleological and deontological approaches are overcome in Islamic ethics. Islamic ethics ensure the right deeds and decisions to create positive

results that benefit to everybody in the society. Thus, the decision maker must act in compliance with the Sharia principles that shape the moral and religious code of conducts, which guarantee the right actions and positive outcome decisions (Mohammad & Quoquab, 2016). In fact, there are five main objectives of these Sharia principles, which are ensuring religion, life, mind, race, and property of humans are properly safeguarded (Salin et al., 2012). From the Islamic standpoints, every intention, word, or deed will be rewarded hereafter. Different from other religions, Islam regards economic activities as an obligation since they pave the way for the economic and social welfare (Ali, 1995).

### **The Role of Islamic Work Ethics in Corporate Governance**

According to Rizk (2008) work in Islam is regarded as a worship “Ibadah” and straggle “Jihad”, individuals are encouraged to be involved and participated in economic activities. Work hereby is not only a means of sustaining a prosperous and healthful society but it is a divine call as well. the work value in the Islamic work ethics results from the accompanying intentions instead of the work outcomes. Consequently, the most important aspect of work as an ibadah and jihad is the intention (Ali, 1988). In Islam, the intention behind every man’s deed must be directed ultimately for Allah SWT. Rasulullah PBUH in Hadith stated that: “Certainly Allah looks not at your wealth; instead, He looks at your heart and your deeds”. Therefore, work must be done sincerely to obtain Allah’s pleasures as stated by the Quran: “Say; verily I am commanded to serve Allah with sincere devotion” (Al-Qur’an, Al Zumar: 14). Sincere intention guarantees that the work is done in an effective and efficient way according to the revealed guidance which contributes to “al-falah” (the state of being successful in this world and the hereafter) (Kamaluddin, 2010).

According to Kamaluddin (2010), Islam as a system is fundamentally unlike other predominant conventional systems since it has “maqasid al-shariah” (objectives) that must be achieved by Muslims through the implementation and exercise of shariah, so that they can realise al-falah or the success of Muslim’s life in this world “Donia” and the hereafter “Akhirah”. These maqasid or objectives constitute the safeguarding of Muslims’ al-dharuriyyah al-khams (essential needs), which comprise of hifz al-deen (the safeguarding of faith), hifz al-nafs (the safeguarding of life), hifz al-aql (the safeguarding of mind), hifz al-nasb (the safeguarding of race) and hifz al-maal (the safeguarding of wealth) (Chapra, 1992). The safeguarding of faith is the supreme component of Shariah, since faith makes humans behave in a proper way (the sirat al-mustaqim). In addition, faith gives human a moral filter (Chapra, 1992) for the consumption, allocation and distribution of resources, in that way the Islamic finance objectives can be realized.

Islamic finance objectives are to create a wide-based economic wellbeing with optimum level of employment and economic growth, to reach socio-economic justice where income and wealth are distributed equally, to achieve stability in money value, to achieve economic development through mobilizing and investing of savings in an equitable manner, and to develop an effective service of the banking system as expected by society (Chapra, 1985). In the business conduct, this exhibition of faith could constitute a powerful tool that mitigate all shapes of misconducts or moral hazards in the context of contractual relationship (Kamaluddin, 2010). Thus, the exhibition of faith through practicing IWEs constitutes a safe shield against financial fraud associated resulted by misconducts of corporate governance mechanisms.

## Conclusion

in the battle against corporate fraud, ethical obligations derived from religion are found to be more effective than the regulations' obligations derived from conventional codes of ethics. As indicated in this study, focusing on laws and regulations in shaping managerial behaviour seems to be worthless as the problem of financial frauds and scams is occurring more frequent all over the world, indicating the failure of CGMs. Furthermore, the current preference of technical characteristics of CGMs over IWEs could be the reason behind CGMs failure in mitigating financial frauds and scams in Islamic institutions. Being rooted in Islamic Shariah, Islamic Work Ethics differs from other conventional ethical systems like teleology and deontology. It was concluded that IWEs are more ethical as it overcomes the shortcomings of these two main conventional ethical systems. In Shariah, every intention, word, or deed will be rewarded hereafter. The five main objectives of Sharia principles, which are ensuring religion, life, mind, race, and property of humans are properly safeguarded, provide a protection shield to Muslims against any misconduct in their work, including those entrusted with CGMs duties. As the exhibition of faith determines the managerial behaviour of employees assigned with CG responsibilities. Hence, IWEs are concluded to be the solution of corporate crime and business community should pay attention to the characteristic of IWEs as ethics based on laws and regulations are proven to be useless in practice.

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