

# THE ADOPTION OF A NEW MODEL OF ISLAMIC CORPORATE SOCIAL RESPONSIBILITIES (I-CSR) IN MITIGATING THE LIKELIHOOD OF FRAUDULENT FINANCIAL REPORTING

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**Abstract:** *Financial reporting issues have been debated endlessly by previous studies using various theories and predictors. Besides, Malaysian Code of corporate governance have been revised few times following the fall of high-profile corporate scandals like Enron in 2007, 2012 and 2017 respectively. However, these revisions seem unable to curb the occurrence of fraudulent financial reporting in Malaysia. As a proof, recently there is a case of false submission of financial statement to Bursa Malaysia. Thus, the objective of this study is to fill in the gaps in the previous literatures by proposing that the new CSR model from Islamic perspective known as Islamic Corporate Social Responsibilities (I-CSR) in mitigating the likelihood of fraudulent financial reporting in Malaysia. A secondary literature review was conducted to identify the Islamic elements which can be embedded into CSR framework. This study has identified four Islamic elements from the previous literatures namely Islamic economic responsibilities, Islamic legal responsibilities, Islamic ethical responsibilities and Islamic philanthropic responsibilities. Thus, this study proposed that companies with I-CSR in practices less likely to engage in any fraudulent financial reporting activities. This study provides important insights to the practitioners and regulators in identifying the suitable mechanism to reduce the likelihood of fraudulent financial reporting by incorporating Islamic elements into CSR disclosure framework.*

**Keywords:** *Ethical Values, Islamic CSR Disclosures, Fraudulent Financial Reporting*

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## Introduction

The issues of fraudulent financial reporting have been discussed expansively worldwide for the past two decades. In Malaysia, two most publicized cases in 2007 were Megan Media Holdings Bhd (MMHB) and Transmile Group Bhd for submitting false financial statements concerning companies' revenues to Bursa Malaysia Securities Bhd (Securities Commission Malaysia, 2021). These white-collar crimes have caused the Malaysian regulators to amend code of corporate governance three times in 2007, 2012 and 2017 respectively to improve corporate's accountability and transparency (Zin et al., 2020). Such actions have been taken because these fraudulent activities have a harmful impact to the company and its shareholders specifically as well as to general public as a whole. The Association of Certified Fraud Examiners have revealed that financial statement fraud has caused companies suffer a huge amount of losses which is at a median loss of \$3,000,000 US Dollars (ACFE, 2020). Nevertheless, it is still unable to curb the occurrence of fraudulent financial reporting in Malaysia. As a result, the public as potential shareholders have lost their trust on the companies' accountability and transparency.

Previous discussion has debated various factors could be the possible reasons for the occurrence of fraudulent financial reporting such as financial pressures faced by the companies, opportunities from the loopholes in the companies' internal control system and managers' rationalization from the fraud triangle theory's perspectives (Dewi & Adib, 2020; Fitri et al., 2019; Hashim & Salleh, 2020), CEO's capabilities from fraud diamond theory (Omukaga, 2020; Sari et al., 2020; Tenku Sulaiman & Ahmad, 2017) CEO's arrogance from fraud pentagon theory (Devi et al., 2021; Puspitha & Yasa, 2018; Rahmatika et al., 2019). Besides, previous studies also discovered that low levels of integrity among top management of the company can lead to higher levels of misconduct including fraudulent financial reporting (Saluja et al., 2021). Thus, from the above reviews it can be concluded that the people with high level of integrity could obstructs them from committing fraud even if the other three elements are present.

Furthermore, corporate ethical values play a vital role in mitigating the fraudulent financial reporting (Rodgers et al., 2015). Previous literatures have discovered that ethical decision-making model consist of six elements namely ethical egoism, deontology, utilitarianism, relativist, virtue ethics and ethics of care in the fraud theory and concluded that ethical issues such as conflicts of interest, unlawful or other improper payments, additional labour, receiving presents from suppliers, and other ethical issues can all be addressed more effectively through ethical positions (Rodgers et al., 2015). Besides, Liao et al., (2019) and Harjoto, (2017) have found that CSR has a negative and significant relationship with fraud incidence, indicating that CSR could effectively reduce the risk of fraudulent financial activities especially companies which engage in CSR on a voluntary basis. However, other studies have found that companies boost their CSR performance significantly when conducting financial fraud, which supports the hypothesis that self-interested managers use CSR performance deliberately to coordinate with their fraudulent financial reporting (Li et al., 2019). Another study examined the regularity and timeliness of new CSR contributions among companies that have engaged in corporate misconduct. They discovered that companies who engage in illegal price fixing schemes had boosted their CSR efforts around the time they are investigated for alleged violations, not earlier (Ferrés & Marcet, 2021). Thus, it can be concluded that there is inconsistencies in the previous findings which need further investigation on this topic.

The above reviews show that there is a practical gaps and empirical gaps in the previous studies evidenced by the inconsistencies in the previous findings on the relationship of CSR disclosures and fraudulent financial reporting. Thus, the objective of this study is to fill in the gaps by

crafting the new model of Islamic CSR disclosure (I-CSR) in mitigating the likelihood of fraudulent financial reporting due to the importance and relevance of the topic. This type of study is critical for finding knowledge gaps that could be investigated in order to develop useful and practical research (Fragoso et al., 2020).

## Literature Review

### Islamic Corporate Social Responsibility Disclosure (I-CSR)

CSR can be best defined by Tsoutsoura as quoted by Abdulrazak & Ahmad (2014) as “a comprehensive set of policies, practices and programs that are integrated into business operations, supply chains and decision-making processes throughout the company and usually include issues related to business ethics, community investment, environmental concerns, governance, human rights, the marketplace as well as the workplace”. Bursa Malaysia has set a CSR framework to be followed by all public listed companies covering four elements namely the environment, community, workplace and marketplace (Bursa Malaysia, 2006). CSR disclosure began deliberately in Malaysia due to a lack of understanding of the value of CSR disclosures to a company's success, and no regulatory mandate was enforced by the regulatory authorities on the subject (Amran & A. K., 2009).

Furthermore, Ahmed Haji (2013) has found that the extent of CSR disclosures increased between 2006 and 2009. These might be due to the recent amendment to the corporate governance code in 2007. The recent global financial downturn, and the introduction of numerous CSR awards, as well as the mandatory CSR requirement in the Malaysian corporate environment, are some of the factors that could be attributed to the increase in CSR disclosures in Malaysia. However, the recent studies conducted by Said et al., (2018) which have examined 80 shariah compliant companies from year 2012 and found that *the Maqasid Al- Shariah's CSR Disclosure Index* is generally low and those companies disclosed more community theme and intellect element in their annual reports. The same finding was found from previous studies which examined a sample of 175 Shariah public listed companies between 2007 and 2017, it was found that CSR is growing in Malaysia, however it is still low level. The most CSR items disclosed in the annual report was “Community” theme and the lowest theme disclosed was “Workplace” (Aziz & Haron, 2021).

From the above review, it can be concluded that the level of CSR disclosures has shown some improvement among public listed companies in Malaysia after some intervention from the regulatory bodies. Although the recent studies found that the state of CSR disclosures is at a low level, this has proven that the company has fulfilled its social responsibility by focusing on the contributions to the local community (Aziz & Haron, 2021; Said et al., 2018). This is in line with the prominent theory in the CSR field namely stakeholder's theory, which suggesting that the managers who disclose more financial and non-financial information for decision making, will lead to increase in the financial and CSR performance (Velte, 2016). The following is the discussion of the embeddedness of Islamic ethical value into CSR practices which lead to the development of a new model known as Islamic Corporate Social Responsibility (I-CSR).

### CSR from Islamic Perspective

Khurshid et al., (2014) have conducted a study by reviewing the Quranic verses and previous literatures to develop an Islamic CSR model. The developed model consists of four components namely Islamic economic responsibility, Islamic legal responsibility, Islamic ethical responsibility and Islamic philanthropic responsibility. First component is Islamic economic responsibility where the Muslims are encouraged to conduct business based on all the Islamic

guidelines and avoiding the unlawful concepts such as *Riba* or interest in the business transactions. The second component is Islamic legal responsibility which recommend that the business practises adhere to basic Islamic ethical standards in commercial transactions. These rules serve as a framework for politeness, civility, and ethical excellence. All of these regulations reflect societal accountability in all parts of transactions which emphasizing on justice and avoiding any unethical behaviours in business operations. Thirdly, Islamic ethical responsibility which stated that Muslims should be governed by set of ethical principles such as honesty, humanism, and respect for the law in their actions, words, feelings, thoughts, and intentions. Besides, Islam also requires all Muslims to consider specific standards and moral codes and Islamic rules and regulations in business transactions, personal matters including relationship with others. Lastly, Islamic philanthropic responsibility which emphasizing Muslims to generate profits in business without impairing people and environment. Besides, Islam also encourages people to pay Zakat (alms) and Sadaqah (tithes) to prevent the concentration of wealth in a few hands, to redistribute resources, to close social gaps, and to share the fortunes of the wealthy with the unfortunate (charitable donations). Finally, this Islamic CSR model has addressed all aspects of corporate responsibility, including Islamic business practises, legislation and rules, a code of ethics for conducting business, and social contribution to the community through Zakat and donations.

In addition, Pazil et al., (2019) have conducted a study to examine the practice of Islamic CSR based on *Maqasid Shari'ah* among Muslimpreneur in Kelantan. They have identified four activities namely responsibility towards family and the less fortunate, obligation to pay Zakat, helping orphans and the poor and developing the community economic strength in implementing the Islamic CSR. Based on the Analytic Hierarchy Process (AHP) in identifying the prioritize activities in implementing the i-CSR, the study discovered that the most significant activity is the obligation towards family and the less fortunate. The obligation to pay zakat is the second most important activity in implementing the i-CSR, followed by developing community economic strength. Helping orphans and the underprivileged is the least prioritised action in executing the i-CSR (Pazil et al., 2019). Thus, SMEs in Kelantan have practiced the CSR activities based on the *Maqasid Shari'ah* principle through contribution to the society at large.

Furthermore, Koleva (2021) has conducted grounded theory approach to explore the impact of Islam on the CSR practices in the Middle East region. The results from a series of interviews with the leaders of 63 organizations from Saudi Arabia, the United Arab Emirates and Oman discovered that religion (Islam) is very important to all the participants, and that their religion helps them understand and make meaning of CSR, implying that Islam played a big role in the construction and co-creation of the CSR phenomena in the sample companies. Some Islamic principles have been embedded in the Islamic CSR practises in the Middle East region such as *Taqwa*, *Sawn*, *Insaniya*, *Zakat*, *Sadaqah* and *Auqaf* (form of contribution to the community), *Tazkiyyah*, *Ilm*, and *Itar* (contribution to the community and employee's development), *Adl* (fairness to all employees), *Ehsan* (professionalism and work ethics to employees and customers), *Amanah*, *Ikhlās* and *Niyya* (put trust in place for shareholders, regulators and partners) and *Emara* (CSR practices which save environment). Therefore, CSR activities in the Middle East have been practiced in line with the religious principles which covers all group of stakeholders.

On the other hand, Alfakhri et al., (2018) have explored how consumers in Saudi Arabia perceived CSR from an Islamic perspective. Using qualitative approach of 34 in-depth interviews, they had developed an Islamic "CSR Tree" model that consists of three parts: roots,

trunk, and crown, based on the integration of the participants' perspectives and to describe the private or hidden portion of CSR. The trunk and top are visible, but the roots are covered. Any tree's roots are vital to its survival because they keep the tree alive. The concept of private social responsibility, like the roots of a tree, is critical to every organization's strategy, which includes values, intention, and *Sadaqa*. The second component is the tree's trunk (internal social responsibility). The trunk of a tree is the section of the tree that connects the crown and roots. Employees, managers, and anyone who deal directly with the company can see this section. This involves responsibilities to employees in order to meet their needs, as well as Zakat to meet the needs of society at large. Lastly, is the crown (external social responsibility). The crown of a tree is the highest and most visible section of the tree. This section symbolizes an organization's corporate image. People appraise each tree based on its outer appearance. Thus, companies' contribution towards customers, society, shareholders, and environment would represent their distribution of external social responsibilities.

From the above review, past studies have revealed that companies in Islamic countries have incorporated Islamic principles into their CSR practices. This is because they have conducted business based on Islamic principles by avoiding from things that are forbidden in Islam. Therefore, this study believes that the Islamic principles embedded to the CSR practices is able to curb the practice of financial reporting fraud in Malaysia. The following is the discussion of CSR disclosures and the likelihood of fraudulent financial reporting.

#### **CSR Disclosures and the Likelihood of Fraudulent Financial Reporting**

The National Commission on Fraudulent Financial Reporting has defined fraudulent financial reporting as an intentional or careless behaviour, whether an act or an omission, that results in materially misleading financial statements. Financial reporting fraud can be induced by a range of factors and manifest itself in a variety of ways (Treadway Commission, 1987). Discussion of the previous studies centred on the poor structure of corporate governance as a root factor causing the fraudulent financial reporting such as board ethnicity, executive directors on the Board and higher audit fees (Nasir et al., 2019). Nevertheless, the amendment of code of corporate governance seems unable to curb the occurrence of fraudulent financial reporting in Malaysia. Previous studies have discovered that companies with a practical corporate ethical approach would reduce the fraudulent activities among staffs in financial institution (Innocent et al., 2020). Thus, this study perceived that companies with good corporate ethical approach could have good CSR practices which eventually reduce the likelihood of fraudulent financial reporting.

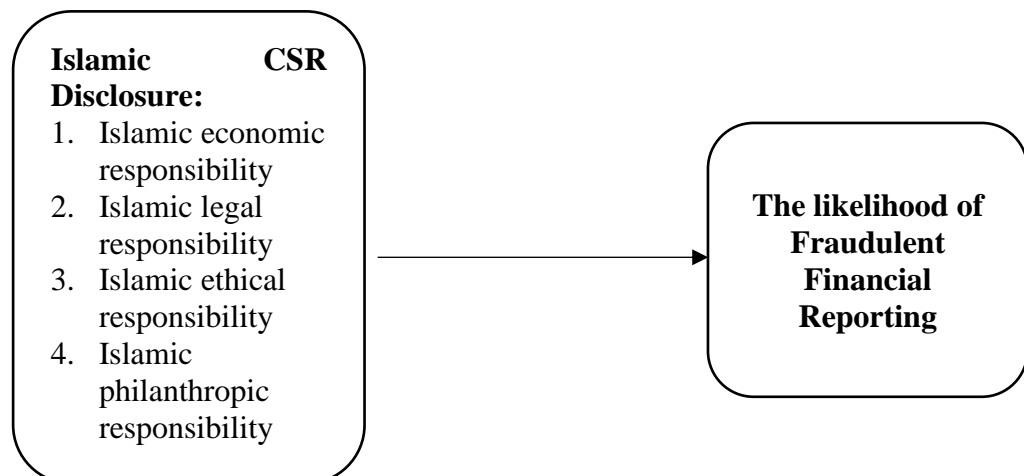
Alsaadi et al., (2017) have conducted a study to investigate the effect of two potential sources of ethical principles namely CSR disclosures and a membership in Shariah Index on companies' earnings quality. They found that companies that have a high level of CSR are less likely to engage in earnings management, whereby membership in a Shariah index, on the other hand, results in earnings manipulation. Besides, other studies also found the negative relationship between CSR performance and fraudulent financial activities among companies in China (Liao et al., 2019). Next, Harjoto (2017) has utilised the cognitive moral development theory and discovered that companies with higher CSR score would reduce the likelihood of corporate fraud. On the other hand, Li et al. (2019) have found that CSR performance among fraudulent companies is higher as compared to non-fraudulent companies during fraud-committing period especially when companies have weak corporate governance system and located in high-religiosity states. Besides, Ferrés & Marcet (2021) which investigated the timing and the stability of new CSR investment of companies involved in fraud. They have found that companies have increased their CSR disclosures when they were under a regulatory

investigation. As a result, this study predicts that companies' engagement in CSR initiatives, as evidenced by increased disclosure, will reduce the likelihood of fraudulent financial reporting.

The researcher identified an apparent knowledge gap in the prior research concerning the Islamic CSR disclosures on the fraudulent financial reporting activities. Previous research has addressed several aspects of ethical decision making (Rodgers et al., 2015), CSR performance score (Harjoto, 2017; Li et al., 2019; Liao et al., 2019), the timing of CSR investments (Ferrés & Marcet, 2021) and consumers' confidence and behaviour on companies with fraudulent financial activities (Thiesen, 2020). However, the previous research has not addressed the impact of Islamic CSR practices and disclosures in mitigating the likelihood of fraudulent financial reporting. Thus, this study proposes the following hypothesis: There is a negative relationship between Islamic CSR disclosures and practices on the likelihood of fraudulent financial reporting.

### Research Framework

Figure 1 below shows the proposed research framework for this study.



**Figure 1: The Adoption of a New Model of Islamic CSR Disclosures in mitigating the likelihood of fraudulent financial reporting**

### Conclusion and Recommendation

The incident of financial reporting fraud that has been going on for nearly two decades has caused the public to lose faith in corporate transparency. Transparency of financial reporting is an essential element of good corporate governance that ensures the sustainability of public companies around the world. This study suggests that Islamic ethical values that have been inculcated in CSR practices should be taken into account in minimizing corporate fraud. This is because Islamic values are based on faith and devotion to God which Islam provides a comprehensive guide to organize all elements of life including economic activities and trade. Previous studies have employed various Islamic elements into CSR practices namely Islamic economic, legal, ethical and philanthropic responsibilities. Besides, some studies have embedded *Maqasid Shari'ah* principles such as responsibilities towards family and less fortunate peoples, orphans, obligation to pay zakat and community. Thus, by incorporating Islamic values in CSR practices the company is able to achieve its objectives while improving the welfare and social wellbeing.

Furthermore, the new model of Islamic CSR disclosures could improve the present CSR since Islamic CSR can improve current CSR practices as it covers all four (4) aspects of CSR namely society, employees, environment and market. This is because, the findings of previous studies show that there are gaps in the practice of CSR among public companies, most of which disclose more on contribution to the community (Aziz & Haron, 2021; Pazil et al., 2019; Said et al., 2018) and put less emphasize on workplace (Aziz & Haron, 2021). The Islamic CSR framework which have been practiced by companies in the Middle East covers all four aspects of CSR as the Islamic principles have been embedded in the Islamic CSR practices such as *Zakat* and *Sadaqah* as a form of contribution to the community, *Tazkiyyah*, *Ilm*, *Itar* and *Adl* are forms of contribution to the employees, *Amanah*, *Ikhlas* and *Niyya* where the company maintain good relationship with the shareholders, regulators and partners and *Emara* where company adopts a principle to save environment (Koleva, 2021). Thus, the new Islamic CSR model can improve current CSR practices among public companies which will lead to business sustainability and reduce the likelihood of fraudulent financial reporting.

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