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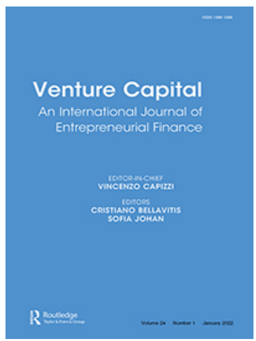

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Entrepreneurial finance, agency problems and Islamic ethics: complementarities and constraints

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ABSTRACT
This paper examines the interactions between Islamic ethics related to entrepreneurs and finance and discusses their implications on entrepreneurial finance. The practice of Islamic entrepreneurial ethics creates trust that helps to mitigate agency problems. In such cases, investors can use contracts involving Islamic financial ethics. However, in the absence of the practice of normative entrepreneurial ethics, agency problems arise that need to be resolved contractually. This paper argues that Islamic legal and ethical principles impose constraints on contractual forms which reduce the flexibility of mitigating agency problems arising in entrepreneurial finance. When entrepreneurial ethics are not practiced, investors can finance entrepreneurs by diluting Islamic financial ethical principles to alleviate agency problems.

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1. Introduction

Entrepreneurial finance has to deal with unique risks arising in new enterprises due to the opacity of information, a lack of track records and the absence of acceptable collateral. Other than business risks, investors also face risks arising from various agency problems that result from the diverse objectives of entrepreneurs and investors. Specifically, investors face asymmetric information problems in the form of adverse selection in the pre-investment stage and moral hazard problems in the post-investment stage (Maxwell and Levesque 2014; Triantis, 2001). Due to these reasons, traditional banks are reluctant to finance start-ups and initial funding often comes from entrepreneurs' own resources, friends and family, and also from angel investors and venture capitalists (Berger and Udell 1998; Denis 2004).

Agency theory suggests that agency problems in entrepreneurial finance can be reduced by screening entrepreneurs to limit the divergence between the interests of investors and entrepreneurs and also by devising comprehensive contracts to abate the latter's adverse behaviour (Fama and Jensen 1983; Jensen and Meckling 1976). Although using appropriate contracts can create the right incentives for entrepreneurial behaviour and give investors control over operations of the venture, agency problems cannot be completely eliminated through contracts (van Osnabrugge 2000).

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An alternative perspective for mitigating agency problems beyond legalistic contractual means is to introduce ethics in financial relationships. Ethical parties are expected to be truthful in providing correct information and fulfilling their contractual commitments, which can enhance trust, mitigate agency problems and reduce the direct and indirect costs arising from the implementation of contracts (Boatright and Peterson 2003). Ethics, therefore, can be considered as a substitute for legal approaches to the costly control, monitoring and verification of contracts in entrepreneurial finance. Even though ethics is important in financial relationships, it is overlooked in entrepreneurial finance (Drover, Wood, and Fassin 2014).

Islamic entrepreneurial finance is crucial for promoting entrepreneurship and financial inclusion in countries with large Muslim populations since a significant number of entrepreneurs may be reluctant to use conventional financing that is not compatible with Islamic laws and ethics.[1] Other than prohibiting certain types of transactions such as interest-based loans and derivatives, Islamic principles also introduce ethical values in contractual relationships (Aribi and Arun 2015; Walsh 2007). Specifically, the Islamic ethical principles of fairness and justice provide guidelines on the fair allocation of risk and returns between the entrepreneur and financiers.

While some studies assert that Islamic values and principles promote entrepreneurship (Adas 2006; Akbar 1993; Davis 2013; Kayed and Hassan 2010, 2011; Ramadani et al. 2015), the literature examining Islamic entrepreneurial finance and ethics is scant.[2] The meagre studies on Islamic entrepreneurial finance discuss how some Islamic financial contracts can be used to finance entrepreneurs (Ahmed 2005; Al-Suwailem 1998). Since Islamic law forbids interest-based lending, these studies recommend using risk-sharing partnership contracts (*musharakah*) to finance entrepreneurs.

Suggestions of using *musharakah* contracts, however, fail to address how Islamic contracts can mitigate key agency problems arising from financing entrepreneurs. Financial relationships between parties during contemporary times are impersonal and entrepreneurs may fail to apply Islamic ethical principles.[3] In such cases, agency problems arise in financing that need to be mitigated. While a few studies cover the agency problems arising in Islamic financial contracts and identify the ethical principles such as sincerity and truthfulness that can resolve them (Aljifri and Khandelwal 2013; Iqbal and Mirakhor 2004), the agency problems arising in Islamic entrepreneurial finance in the absence of Islamic entrepreneurial ethics have not been discussed in the literature.

This paper analyses Islamic entrepreneurial finance and addresses the following research questions: what role do Islamic ethics and contracts play in resolving agency problems in entrepreneurial finance and to what extent can Islamic financial contracts be used to mitigate agency problems in the absence of Islamic entrepreneurial ethics? Being a conceptual paper, it uses the qualitative research method of document analysis and synthesizes information from the relevant literature and Sharia standards. The paper concludes that the extent to which risk-sharing Islamic contracts can be used to finance entrepreneurs will depend on the level of practice of entrepreneurial ethics.

The paper contributes to the meagre literature on Islamic entrepreneurial finance and ethics in several ways. First, the paper explores the role of ethics in Islamic entrepreneurial finance by examining entrepreneurial ethics and financial ethics. Although there are studies examining business ethics that also apply to entrepreneurs, literature on Islamic ethics and entrepreneurial finance is negligible. Moreover, while most of the literature

focuses on normative ethics with little reference to the positive ethics that are practiced in reality, this paper considers the implications of both normative and positive ethics in entrepreneurial finance.

Second, this study is among the meagre research examining agency problems arising in Islamic entrepreneurial finance. The scant literature on Islamic entrepreneurial finance has, prior to this, argued for the use of simple Islamic contracts without addressing how agency problems can be resolved. While Islamic entrepreneurial ethics can help mitigate agency problems and promote financing start-ups, Islamic legal and ethical principles impose constraints on how Islamic entrepreneurial financial contracts can be structured to alleviate agency risks.

Finally, the paper shows the limits of Islamic financial ethics in mitigating agency problems arising in financing entrepreneurs which can lead to outcomes that dilute Sharia principles. By arguing that in the absence of entrepreneurial ethics it is difficult to structure incentive-compatible contracts that mitigate agency problems due to the constraints imposed by Islamic financial ethics, the paper concludes that opportunistic entrepreneurs can be financed by compromising on certain financial ethical principles stipulated by Sharia.

The paper is organized as follows. The second section reviews the relevant literature on entrepreneurial finance, agency problems and ethics. After identifying the agency risks arising in entrepreneurial finance and the ways in which these are mitigated contractually, aspects of entrepreneurial ethics and financial ethics are presented. Section three presents the methodology and the analytical framework used in the paper. While section four discusses the normative Islamic ethics governing entrepreneurs and entrepreneurial finance, the fifth section presents three cases of Islamic entrepreneurial finance under different assumptions of normative/positive entrepreneurial and financial ethics. The last section concludes the paper.

2. Entrepreneurial finance, law and ethics: literature overview

2.1. *Entrepreneurial finance, agency costs and contracts*

Typically, entrepreneurial finance involves an investment cycle that entails selecting and structuring investments, managing and monitoring, and exiting (Gompers and Lerner 1999). Angel investors and venture capitalists are initial external investors who provide funds in the early stages of an entrepreneurial firm (Berger and Udell 1998; Denis 2004; van Osnabrugge 2000). Beyond business risks, investors face additional risks arising from asymmetric information problems that take the form of adverse selection and moral hazard problem. Investors provide financing if the risks arising from both the business and agency relationships can be mitigated to ensure a profitable return upon exit. Possible exit routes that venture capitalists can take include the issuance of public offerings (IPOs), acquisitions, secondary sales, buybacks and write-offs (Cumming and MacIntosh 2003).[4]

Assuming contracting parties are opportunistic and have different information, agency theory identifies the problems of adverse selection and moral hazards arising in cases when ownership and control of a firm are separated (Jensen and Meckling 1976; Fama and Jensen 1983; Noreen 1988). Adverse selection is a pre-investment stage information

asymmetry problem in which the entrepreneur has more information on her own skills and capabilities and the prospects of the enterprise than the investors who cannot observe or verify these completely. Moral hazard problems arise in the post-investment stage and relate to opportunism that can result from the incentives of the entrepreneur to work for her own interests instead of that of the investors (Maxwell and Levesque 2014; Triantis, 2001). This can happen if the entrepreneur either uses resources which benefits herself at the cost of the investors or puts less effort into the venture than what was agreed upon in the financing contract.

While the adverse selection problem can be mitigated by screening the entrepreneur to limit the divergence of the investors' interests with that of the entrepreneur, agency theory focuses on resolving behavioural problems by using a "nexus of contracts" that instil appropriate incentive schemes to deal with entrepreneur behaviour (Fama and Jensen 1983, 302). Since every detail cannot be included in contracts and they are incomplete, disagreements can arise on the duties and legal requirements of the parties concerned.

The transaction costs theoretical perspective assumes that individuals are opportunistic and have bounded rationality (Williamson 1988). Limited cognitive competence due to bounded rationality can restrict comprehensive contracting and result in incomplete contracts. A key issue in entrepreneurial finance is asset specificity, which increases the risks of investments since specific specialized assets cannot be redeployed or sold in case of a breach of contract. The problem is exacerbated in complex products where contracting parties have incomplete knowledge and thus limited cognitive ability to understand them (Ryan, Buchholtz, and Kolb 2010).

To deal with these problems, the transactions cost theory focuses on "governance structures that economize on bounded rationality while simultaneously safeguarding the transactions against the hazards of opportunism" (Williamson 1988, 569). Governance structures include allocating power that gives the investors control over operations of the enterprise to enhance the integrity and compliance with contracts (Hart 1995; Williamson 1988).

Given the assumptions of self-interest, asymmetric information and bounded rationality, investors use appropriate contracts to resolve conflicts of aligning and verifying goals to ensure returns from investments. Financial contracts are devised to create appropriate incentives for the entrepreneurs to achieve the stipulated goals and allow investors to take full control of the enterprise if the entrepreneur performs poorly (Kaplan and Stromberg 2003). While investors can choose from a variety of contracts to finance entrepreneurial firms, they usually use convertible preferred stocks that include stipulations providing additional rights to deal with agency problems (Denis 2004; Cumming 2006).[5]

2.1. 1. Contractual tools to mitigate agency costs

Four key contractual tools used by investors to mitigate agency problems arising in entrepreneurial finance can be identified. First, "control rights" give investors enough control over the enterprise to limit the decisions of the entrepreneur which are detrimental to the interests of the investors. They often get direct control rights by having a controlling majority stake and by acquiring board membership (Kaplan and Stromberg 2001, 2003). In some cases, the board control can be state-contingent and increases if certain performance benchmarks are not met by the entrepreneur (Denis 2004).

Investors can also obtain certain veto rights and decision-making rights on major transactions (Fried and Ganor 2006). Investors can secure the right of first refusal that entitles them to invest first and anti-dilution clauses which protect their ownership share in subsequent future rounds of investment (Denis 2004; Burchardt et al. 2016; Kaplan and Stromberg 2001, 2003).

Second, agency problems can be mitigated contractually by creating "incentive structures" that induce the entrepreneur to exert her optimal efforts to enhance the value of the enterprise. Investors indirectly control the operations of the firm by instituting appropriate incentives to make the cash-flow rights of the entrepreneur, such as compensation and stock ownership, contingent on her performance. Not only is the compensation of the entrepreneur related to the venture's value, but the residual cash flows and stock ownership can also be linked to her performance (Kaplan and Stromberg 2003).

Another way in which investors can influence the decision making of entrepreneurs is to use staged financing whereby capital is provided in stages upon meeting certain milestones or benchmarks (Burchardt et al. 2016; Fried and Ganor 2006; Denis 2004). In cases where performance is lower than expected, investors will have the right to stop financing or to abandon the venture (Gompers 1995).

Third, the investors can ensure "preferential cash-flows" by employing pre-determined fixed dividends for their preferred stock holdings. The contracts of financing would include various stipulations related to cash-flow rights at different stages of the investment cycle. Preferred stocks also give investors the right to obtain a disproportionate share of the enterprise if the entrepreneur fails to achieve parts of the agreed upon business plan (Denis 2004). Since the enterprise may not turn a profit during the initial stages of operations, the cumulative dividends are not paid out and realized at the time of exit (Kaplan and Stromberg 2003).

Finally, "liquidation rights" institute preferential shares for investors in liquidation since investors make their returns on exiting. Convertible preferred stock gives investors the right to convert their securities into common stock at favourable prices in case of initial public offering (Denis 2004; Smith, Smith, and Bliss 2011). Furthermore, preferred stocks have senior claims in liquidation which protect investments in case of the poor performance of the company (Bottazzi 2009; Kaplan and Stromberg 2003).

A feature of senior liquidation rights is that the investors get back at least the original amount invested. One way in which this can be done is by making the conversion of preferred stock to the number of common stock dependent on the value of the firm (Bottazzi 2009; Kaplan and Stromberg 2003). If the valuation of the venture at the time of liquidation is relatively small, the investors would then get a disproportionately larger share of the proceeds by using higher conversion ratios between preferred stock and common stock.

2.2. Entrepreneurial finance and ethics

While the legalistic perspective considers using contracts as a power-conferring tool, contracts can also be viewed as a duty-imposing instrument from an ethical perspective whereby parties to the contract are expected to fulfil moral obligations and promises (Dagan 2019). The latter assumes business transactions to be human activities involving ethics that include mutually interdependent rules, values and virtues that govern these

activities (Mele, Rosanas, and Fontrodona 2017). Ethical practices build trust that parties will follow the rules of fair exchange and honour their commitments which reduce the direct and indirect costs of implementing contracts (Boatright and Peterson 2003). Thus, ethics can lower costs of compliance and be considered as a substitute for using contracts that use costly verification and control mechanisms.

Ethics relevant to entrepreneurial finance can be discussed in two broad ways. First, ethics can be viewed as normative and positive. The former is prescriptive and relates to "what ought to be" and the latter is descriptive and elaborates on "what is" practiced in reality.[6] Normative theories of ethics include deontological, teleological and virtue ethics. Deontological ethics focus on specific moral acts and obligations, teleological ethics examines the consequences of actions, and virtue ethics relates to the qualities and characteristics of the actor (Akaah 1997; Hunt and Vitell 1986; Moore 2005; Whetstone 2001). Positive ethics relates to the ethical behaviour that exists and is experienced in reality (Singer 2000). Ethical decision-making is determined by the moral dispositions of individuals and is affected by personal experiences and various cultural, industrial, and organizational environments (Hunt and Vitell 1986; Loe, Ferrell, and Mansfield 2000).

The second way of classifying ethics in entrepreneurial finance is to examine the moral issues arising in financial contracting which can be broadly categorized into entrepreneurial ethics and financial ethics. While the former is associated with the *observance of financial obligations* by entrepreneurs, the latter relates to the *fairness in making contracts* by the investors (Boatright 2007, 900). Specific ethical issues which arise in entrepreneurial finance in these categories are discussed below.

2.2.1. Entrepreneurial ethics

Both agency and transaction cost theories assume contracting parties are opportunistic which in its strong form can involve deceit, lying, cheating and theft (Noreen 1988; Williamson 1985). The assumptions of self-interested entrepreneurs and selfish behaviour devoid of ethics exacerbates agency problems since parties are assumed to renege on promises if it can be done safely. Ethical issues arising in entrepreneurial finance are important since entrepreneurs are likely to do anything to succeed (Fisscher et al. 2005). These issues require instituting costly monitoring and oversight mechanisms to ensure compliance with the terms of contracts.

Since contracts cannot be complete to include all eventualities that can arise in the future, relying on good faith and the obligations of fulfilling fiduciary duties can potentially fill the gaps. Entrepreneurial ethics includes virtues and behaviour that increase the likelihood of fulfilling responsibilities honestly and prudently. Gundlach and Murphy (1993) identify that the virtues of an entrepreneur that can make contractual relationships fair and open include trust, responsibility and commitment.[7] The existence of the social norms of fairness reduces moral hazard problems and makes investors willing to offer more equity to the entrepreneur since the risks of appropriation are mitigated (Fairchild 2011).

Developing relationships that create trust among parties can substitute for more formal systems of control using contracts (Maxwell and Levesque 2014). Trust is relevant in situations where there is a risk of the opportunistic behaviour of one party making the other party vulnerable because it provides confidence that the former will behave in ways

that will not jeopardize the interests of the latter (Shepherd and Zacharakis 2001). The ethical practices of fulfilling contractual commitments enhances trust among parties and reduces agency costs (Boatright and Peterson 2003).

2.2.2. Financial ethics

While entrepreneurial ethics focuses on moral principles and the performance of entrepreneurs, ethical issues also arise in the responsibilities of investors and the fairness of contracts. Ethical dimensions in contractual relationships can be linked to the notions of fairness and distributive justice (Gundlach and Murphy 1993). Fairness is important for agents since their incentives depend on their perceptions of how fairly they are treated (Welbourne, Balkin, and Gomez-Mejia 1995). An agent's belief of unfair treatment will reduce her incentives and can adversely affect the interests of the principal.

Justice in financial transactions is reflected in fair conditions in contracts and trading practices. Contracts can be unfair due to inequalities in resources, bargaining power, information availability and processing abilities (Boatright 2007; Fassin and Drover 2017). In situations when outcomes are unjust, legal rules that regulate the terms of a contract can impact distributive justice by constraining elements of private exchange (Bagchi 2014). For example, Kronman (1980) suggests using contract law as an instrument of redistribution and cites the example of usury laws which prohibit charging exorbitant interest rates in loan contracts.

Another perspective of the ethics of justice in contracts is the "fair distribution of costs and benefits among the parties" (Fassin and Drover 2017, 651). Thus, distributive justice in financial transactions can be related to the distribution of risks and returns among parties. Kolb (2011) identifies the ethical issues that can arise in risk bearing and transfer in financial contracts. In some cases, parties will agree to voluntarily take on certain risks due to the nature of a transaction. For example, an investor takes on risks of stock investments in hopes of getting a financial return. However, ethical issues related to distributive justice arise when risk transfer occurs involuntarily due to asymmetric information, deception or undue exercise of power (Kolb 2011).

In entrepreneurial finance, unethical risk transfer in relation to distributive justice can occur in two ways. First, investors financing entrepreneurs face two key risks, the business risks of the venture and the moral hazard risks of the entrepreneur. While the business risks are a part of normal business operations that investors are willing to take, the risks arising from moral hazard problems or the deception of entrepreneurs constitutes the unethical risk imposed on investors by the entrepreneur. Second, investors can act unethically if they unduly transfer the burden of risks and costs of failure to the entrepreneurs resulting from the business risks of the venture due to their superior bargaining power. Since entrepreneurs encounter asymmetries of resources and power relative to investors, conflicts can arise in contractual terms that can lead to unfair outcomes for the former.

3. Methodology and analytical framework

This paper falls under the category of conceptual research and uses qualitative research methods. Conceptual papers provide multi-level insights by linking ideas across different disciplines and bridging existing theories to broaden the scope of knowledge and

thinking (Gilson and Goldberg 2015). Conceptual research usually proposes new relationships among different constructs by developing logical and complete arguments about these linkages rather than testing them empirically (Gilson and Goldberg 2015).

Arguments in conceptual research are not based on data in the traditional sense. Instead they combine and assimilate evidence in the form of previously developed concepts and theories (Hirschheim 2008). Multiple concepts and theories from different literature streams can be used to provide evidence and carry out the analysis (Jaakkola 2020). This would require reviewing the appropriate literature to "unravel the components of a concept" (Jaakkola 2020, 21). One way to do this is to use document analysis which is a "systemic procedure of reviewing or evaluating documents" to find, select, appraise and synthesize data and information contained in the documents (Bowen 2009, 27).

The conceptual framework of this paper is developed by examining relevant concepts from the literature on the role of legal and ethical approaches to resolve agency problems in Islamic entrepreneurial finance. In this regard, Islamic ethics can be distinguished as those related to entrepreneurs and financial transactions on the one hand, and normative and positive ethics on the other hand. While Islamic ethics is a general term that includes different types of ethics, entrepreneurial ethics are prescriptions of behavioral norms that entrepreneurs should have and financial ethics entail ethical values and principles related to financial transactions.

As indicated, normative ethics relates to the norms and principles that *should* be followed and positive ethics reflects what *is* practiced in reality. Normative Islamic ethics are the ethical values and principles specified in the Sharia texts (Carney 1983; Reinhart 1983). Sharia values representing Islamic normative entrepreneurial ethics can be identified from the literature on Islamic ethics related to businesses and entrepreneurs (Abuznaid 2009; Ishak and Osman 2016).

Similarly, normative Islamic financial ethics can be found in literature and standards on Islamic contracts. For the latter, the Sharia standards (AAOIFI 2015) developed by the Accounting and Auditing Organization for Islamic Financial Institutions, an international organization responsible for developing accounting, auditing and Sharia standards for the Islamic financial industry can be used. AAOIFI Sharia standards are considered as benchmark rulings for Islamic finance and have been adopted by different jurisdictions.

While normative Islamic ethics are derived from Sharia texts, these do not inevitably translate into practice in reality (Rexhepi and Ramadani 2017). Beekun (2004) asserts that various factors determine Islamic ethics applied in businesses which include legal interpretations, the environment, the stage of moral development, and organizational and individual factors. As a result, the ethical practices (i.e., positive ethics) among Muslim organizations may turn out to be contrary to normative ethical values (Abuznaid 2009). Opportunistic entrepreneurs seeking their own benefits can choose not to practice the normative ethics prescribed by Sharia. Similarly, the financiers can also dilute Islamic financial ethical principles to achieve their economic objectives. Table 1 summarizes different notions of Islamic ethics relevant to Islamic entrepreneurial finance.

Given the above framework, this paper examines three cases for Islamic entrepreneurial finance under different assumptions of the existence of entrepreneurial and financial ethics (see Table 2). In Case 1 both Islamic entrepreneurial ethics and Islamic financial ethics are practiced and they complement each other to resolve agency problems ethically. Case 2

Table 1. Normative and positive Islamic ethics relevant to entrepreneurial finance.

	Entrepreneurial Ethics	Financial Ethics
Normative	Normative Islamic entrepreneurial norms and principles from Sharia texts and literature	Normative Islamic financial values and principles specified in AAOIFI standards and literature
Positive	Ethics practiced by entrepreneurs (can be different from normative Islamic entrepreneurial ethics)	Ethics practiced by financiers (can be different from normative Islamic financial ethics)

Table 2. Status of Islamic ethics and agency problems.

Cases	Normative Islamic Entrepreneurial Ethics	Normative Islamic Financial Ethics	Agency Problems Mitigation
Case 1	Practiced	Practiced	Mitigated by ethical means
Case 2	Not Practiced	Practiced	Not mitigated
Case 3	Not Practiced	Not Practiced	Mitigated by contractual means

examines a situation when Islamic financial ethics are applied in financing but the entrepreneurs do not act ethically which creates agency problems. Due to the constraints that Islamic financial ethical principles impose on contracts, the agency problems cannot be mitigated contractually. Case 3 presents a situation in which entrepreneurs do not practice Islamic ethics and Islamic financial ethics are diluted to deal with agency problems.[8]

Analysing these cases requires identifying the Islamic normative ethics related to entrepreneurs and financial transactions and then comparing them with practice. The next section presents an overview of the Islamic normative ethics related to entrepreneurs and finance followed by a section that presents the cases.

4. Islamic entrepreneurial finance and ethics

Islamic laws and morals emanate from Sharia texts and are interconnected (Carney 1983; Reinhart 1983). One perspective equates Islamic law with ethics asserting that the former inheres the latter. Under this view, practices are considered ethical if the legal conditions and stipulations of a contract are fulfilled (Walsh 2007). For example, while interest on loans is legally forbidden under the Sharia, a key reason of the prohibition is because it is unequivocally unjust (Siddiqi 2004). Another perspective distinguishes ethics to be distinct from Islamic law and identifies various moral values including those governing economic activities and businesses. According to this view, while Islamic law is legally binding and a breach can be enforced by courts, ethics are moral norms that cannot be contested in the legal system.

Normative Islamic ethics can be distinguished into two types: specific ethics and general ethical principles. Specific ethics are statements in Sharia texts that provide moral guidance on particular issues. An example of specific ethics derived from religious teachings is the Prophetic saying “He who cheats is not one of us” which implies that the fiduciary should perform work honestly and truthfully (Rice 1999, 350). General normative ethics are the broader principles of Islam such as justice, equity, brotherhood, cooperation and the need for balance (Rice 1999; Saeed, Ahmed, and Mukhar 2001).

Another source of the broader notion of Islamic ethics comes from the legal maxims (*qawa’id al-fiqh*) that reflect the spirit of Islamic law and represent the broader values of Sharia.[9] Based on recognized references in Sharia texts, the maxims have

evolved over time to become general principles manifesting the essence of Sharia that can be applied to a variety of cases (Dien 2004, 113). While maxims are too broad to qualify as legal rules, some of them have legal connotations and others have ethical overtures. For example, the maxim "harm is to be eliminated" provides a general ethical principle that governs all activities including economic transactions (Laldin et al. 2013, 117).

Given the above, Islamic ethics related to entrepreneurial finance will include legal principles governing financial transactions and ethics related to entrepreneurs and finance. The next two subsections discuss aspects of Islamic entrepreneurial ethics and Islamic financial ethics.[10]

4.2. Normative Islamic entrepreneurial ethics

Islamic values and principles encourage participation in commercial and economic activities and provide guidelines that cover entrepreneurial activities (Adas 2006; Akbar 1993; Kayed and Hassan 2010; Ramadani et al. 2015). Gumusay (2015) defines entrepreneurship from an Islamic perspective as the pursuit of opportunities to achieve economic goals that are shaped by ethical norms and values and recognizes the spiritual relationship with God.

At the micro-level, an Islamic entrepreneur will be motivated by religious principles and values, and success will be measured by socio-economic and metaphysical achievements in this world and the hereafter. At the meso-level, the various operational aspects of an organization such as strategy, human resources, marketing, finance, and so on will be influenced by Islamic values and principles. Specifically, an Islamic entrepreneur will use Islamic finance for its growth and expansion (Gumusay 2015).

Normative Islamic entrepreneurial ethics focuses on specific actions, behaviours and character traits. A large literature identifies specific ethical qualities and virtues that include good intentions, honesty, sincerity, knowledgeability, responsibility, optimism, consistency, accountability, patience, and so on. (Abuznaid 2009; Ayub 2007; Iqbal and Mirakhor 2004; Ishak and Osman 2016; Rexhepi and Ramadani 2017).

4.3. Normative Islamic financial ethics

Normative Islamic financial ethics will take the form of specific legal principles and ethical values on economic transactions derived from the Sharia. An underlying principle governing financial transactions is the notion of justice as confirmed by a key maxim "The fundamental requirement in every contract is justice" (Laldin et al. 2013, 22). Justice from an Islamic perspective balances the implementation of rights and obligations in contracts (Kamali 2008, 30 & 200).

One way in which Islamic teachings institute distributive justice in contracts is to provide guidelines for the fair allocation of risk and returns in financing. This is reflected in a couple of maxims that links return to the undertaking of risks. These are "benefits goes with liability" (*al kharaj bi daman*) and "liability accompanies gain" (*al ghurm bil ghunm*) (Laldin et al. 2013, 156 & 161). These "returns linked to risks" maxims assert that the entitlement to profit generated from an asset should be associated with the risks of its ownership (Vogel and Hayes 1998).

The basic principle driving Islamic commercial law is permissibility which affirms that all acts are permissible unless there is an injunction to the contrary (Kamali 2000, 66).[11] Two broad categories of prohibition in economic transactions recognized in the *Sharia* are *riba* and *gharar*. *Riba* (literally meaning increase or growth) is prohibited by *Sharia*. Although it is common to associate *riba* with interest, it has a much wider implication and can take different forms. The common premise is that *riba* arises from the unequal trade of values in exchange (Siddiqi 2004). Interest-based loans are prohibited as they are considered *riba*.

Gharar has connotations of excessive uncertainty, risk or hazard and also implies ignorance, gambling and fraud (Al-Zuhayli 2003; ElGamal 2001). *Gharar* relates to asymmetric information problems arising in the object of sale or in the terms of the contract. The former relates to the existence and ability to deliver the object of sale and the latter is concerned with ambiguity in the terms and conditions of the contract.

Since interest-based loans are deemed to be *riba* and prohibited, Islamic financial institutions use different types of permissible contracts to structure financial products. Traditional Islamic modes of financing can be broadly classified into equity, debt and asset-based instruments. Equity instruments are partnership contracts (*mudarabah* and *musharakah*) in which parties contribute capital and labour in a venture. In these contracts, while the profit is shared according to an agreed upon ratio, loss is distributed according to the ratio of capital contribution.

Debt instruments arise from sale transactions in which one of the counter-values of the transaction is postponed to a future date. These constitute fixed-income instruments and include cost-plus or mark-up sale (*murabahah*), credit sale (*bai-muajjal*) and object deferred sale or pre-paid sale (*istisna/salaam*) instruments. Asset-based instruments include leasing (*ijarah*) contracts in which a durable asset is leased out for a period of time in return for rental payments.[12]

The general ethical principle related to distributive justice in contracts expressed in the maxims of "returns linked to risks" mentioned above underlie all Islamic financial contracts. For example, in a leasing contract, the lessor, being the owner, is responsible for any risks arising in the leased asset and as a result is entitled to the rent generated from the asset. According to the maxims, the lessor cannot transfer the risks of the assets to the lessee contractually since she derives the benefits from the asset in the form of rent.

4.3.1. Islamic entrepreneurial finance: legal and ethical principles

A first step to financing an enterprise would be ensure that the firm's activities are Sharia compliant. In this regard, two levels of screenings used to assess the Sharia compliance of stocks can also be applied to screen entrepreneurial firms also. First, firms carrying out certain business activities that are not compatible with Sharia principles are excluded. Products and services prohibited by Islamic law include alcohol, pork, gambling, pornography, and interest-based financial services. Some Sharia scholars also include other activities such as entertainment, cloning, and weapons among the prohibited activities (Derigs and Marzban 2008; Rizaldy and Ahmed 2019).

After the firms pass activities-based screening, a second level of financial screening is carried out to exclude firms with unacceptable levels of debt, liquidity, and non-Sharia compliant income (Derigs and Marzban 2008; Rizaldy and Ahmed 2019). For entrepreneurial firms, the financial screening criteria may not be very relevant since they would have low levels of debt and seek equity capital to expand their activities.

Once the enterprise qualifies as Sharia compliant after the activities-based and financial screenings, the appropriate mode of financing must be determined. The literature on Islamic entrepreneurial finance suggests using *musharakah* contracts to finance entrepreneurs (Ahmed 2005; Al-Suwailem 1998; Kayed and Hassan 2010, 2011). As mentioned, *musharakah* is a partnership between parties in which partners contribute capital and collectively manage the business enterprise. While the profit-sharing ratio among the parties can be negotiated by the partners, loss is borne according to their share of capital contribution. The distribution of losses according to capital share reflects the maxims of "returns linked to risks" whereby risks of losses are linked directly to ownership of capital.

There is a need to examine the Islamic legal and ethical perspectives related to the four contractual stipulations discussed in Section 2 to understand how agency problems can be mitigated in Islamic entrepreneurial finance. To do this, the AAOIFI Sharia standards are used as benchmark normative Islamic rulings governing contracts that can be applied to entrepreneurial finance. Specifically, AAOIFI Sharia Standard No. 12 covering various contractual issues related to equity financing in an enterprise (*sharikah*) is relevant.[13]

First, investors use *control rights* to ensure that the entrepreneur does not take decisions that are detrimental to their interests. This will be possible in a *musharakah* contract as indicated in the AAOIFI Standards Clause 3/1/3/2 which makes control negotiable between the partners who can decide to give investors control rights in the venture (AAOIFI 2015, 330). The investors can also ensure that their ownership rights are protected in subsequent future rounds of investments by securing rights of first refusal and anti-dilution clauses. These conditions can be added in the contract since they do not violate any of the principles outlined in the AAOIFI Sharia standards.

Second, contracts can introduce *incentive structures* that induce the entrepreneur to exert optimal effort by making the returns of the entrepreneur contingent on her performance. Clauses 3/1/5/5 and 3/1/5/8 of the AAOIFI standards allow for the compensation of the entrepreneur to be contingent on her performance. Furthermore, Clause 3/1/5/8 affirms that profit distribution can be realized in a staggered way whereby profit in excess of a target ceiling can be distributed to a particular partner. Thus, incentive structures that reward the entrepreneur for good performance can be included in the contract through a staggered profit-distribution ratio in her favour. AAOIFI Sharia standards do not provide any specific view on the possibility of creating incentives in terms of varying ownership shares in favour of the entrepreneur in case of good performance. However, applying the principle of permissibility, it can be concluded that the investors will be able transfer a part of their shares to the entrepreneur voluntarily in case of good performance.

Third, one of the ways in which investors can structure *cash-flow rights* in their favour is through using pre-determined cumulative dividends in a preferred stock. AAOIFI Sharia Standards prohibit preference shares as stated in Clause 4/1/2/14, "It is not permitted to issue preference shares, i.e., shares that have special financial characteristics that give them a priority at the date of liquidation of the company or at the date of distribution of profit" (AAOIFI 2015, 341). Furthermore, Clause 3/1/5/1 of the AAOIFI Sharia rules prohibits preferential cash flows in a *musharakah* and asserts that the distribution of profit cannot be allocated as a fixed sum of money or as a percentage of the capital and must be based on actual profit.

Table 3. Islamic perspectives on contractual tools of mitigating agency problems.

Contractual Tools	Description	Islamic Ethical/ Legal Perspectives
Control rights	Investors get control over the enterprise to limit the decisions of the entrepreneur that are detrimental to their interests	Permissible
Incentive structures	Cash-flow rights (compensation and stock ownership) of the entrepreneur made contingent on her performance	Permissible
Cash-flows rights	Investors get pre-determined dividends and have the right to obtain a disproportionate share of the enterprise if the entrepreneur performs poorly	Impermissible
Liquidation rights	Investors have preferential shares that are converted into common shares at favourable prices and have senior claims in case of poor performance	Impermissible

Finally, *preferential liquidation rights* that give investors a relatively larger share and senior claims at exit will not be possible where there is a *musharakah*. Contractual structures that distinguish different types of shareholders with different liquidation rights are not permitted under AAOIFI Clause 3/1/5/1 which states that the distribution of the proceeds at exit has to take place at a *pro rata* basis in accordance with capital shares. As no priority is given to the distribution of profits or proceeds from the liquidation of the company and the distribution of losses and proceeds are done according to shares in capital, different classes of stocks based on special financial characteristics such as preference shares are not permitted (Clause 4/1/2/14).

Since different classes of shares are not acceptable, the feature of using favourable conversion ratios of preferred shares to common shares cannot be used under *musharakah*. Thus, unlike conventional entrepreneurial finance, the losses cannot be transferred to the entrepreneur contractually in liquidation due to the maxims linking returns to risks. The Islamic ethical/legal perspectives on the contractual stipulations used to mitigate agency problems in entrepreneurial finance are summarized in Table 3.

5. Islamic entrepreneurial and financial ethics and entrepreneurial finance: cases

This section examines cases with different assumptions of regarding practices of entrepreneurial and financial ethics and discusses how the resulting agency problems can be resolved through legal and ethical means. In this regard, the following issues are relevant for analyzing the cases. First, the appropriate Islamic financial contract used for entrepreneurial financing is the *musharakah* partnership contract. Second, mitigating agency problems contractually is discussed in light of the four tools (control rights, incentive structures, cash-flow rights and liquidation rights) identified above. Finally, ethics related to entrepreneurial finance are viewed in two dimensions: entrepreneurial and financial ethics on the one hand and normative and positive ethics on the other hand.

Positive ethics represents what is practiced by parties which can be different from normative ethical norms (Rexhepi and Ramadani 2017). To assess the status of financial contracts used in reality relative to normative ethics, the maxim of “substance over form” is used. The maxim stating “in contracts, greater attention is given to intention and meaning than words and form” (Laldin et al. 2013, 46) necessitates judging practice relative to normative ethics by examining the substance of the contract rather than its form. Driven by market pressures and seeking to mitigate risks, many Islamic financial institutions use stratagems and develop products that fulfil the form but not the

substance of Sharia, thereby diluting normative Islamic ethical requirements (ElGamal 2008; Hegazy 2007; Neinhaus 2011). Many scholars contend that focusing on form over substance leads to a lack of application of normative ethical principles in Islamic finance practice (Aribi and Arun 2015; Mansour, Jedidia, and Majdoub 2015; Kamla and Rammal 2013; Maali, Casson, and Napier 2006).

Given the above, cases of Islamic entrepreneurial finance under different assumptions of entrepreneurial and financial ethics and the resulting status of agency problems identified in Table 2 are discussed next.

5.1 Case 1: normative entrepreneurial and financial ethics practiced

The existence of normative Islamic entrepreneurial and financial ethics would imply that both the entrepreneur and investors are imbibed with Islamic moral values. In this ideal situation, the entrepreneur will be trustworthy, transparent and work hard to achieve the goals of the venture. The ethical entrepreneur will be honest and reveal the information of the project truthfully *ex-ante* and alleviate the adverse selection problem.

After investments are made, the entrepreneur would then strive to maximize the value of the enterprise without being self-serving and thereby reduce the moral hazard problem and the agency costs arising in financial relations. In other words, the potential losses arising from the unethical moral hazard problems of entrepreneur are eliminated and the investors are only exposed to the business risks of the venture. With high levels of entrepreneurial ethics, the Islamic financing mode of *musharakah* can be used to finance the entrepreneur. As such, the need to instil control and incentive clauses in the contract would be minimal.

The cash flow and returns of investors at liquidation will depend on whether the venture is profitable or incurs losses at the time of exit. Any profit generated by the venture will be distributed between the entrepreneur and investors according to the agreed-upon profit-sharing ratio. However, Islamic legal and ethical principles require that losses be borne by the entrepreneur and investors according to their capital shares in the venture. Contractually, there is no flexibility in the distribution of losses beyond the respective capital shares unless one party willingly agrees to bear a higher share of the losses after the realization of the losses. The investors guided by normative financial ethics are likely to accept losses arising from the business risks of the enterprise in line with the maxim of "returns linked to risks."

5.2 Case 2: entrepreneurial ethics not practiced, financial ethics practiced

The assumptions of entrepreneurs practicing Islamic normative ethics may not be true in reality. In fact, evidence on proxies of ethical status shows that Muslim countries have lower levels of trust and higher levels of corruption compared to world averages. Information from World Values Survey (2020) carried out on 15 Organization of Islamic Cooperation (OIC) countries and 31 non-OIC countries reveals that the proportion of responses for the statement "Most people can be trusted" was 14.4% for the former group and 23.1% for the latter group (with a global average of 22.5%). Similarly, the statement "Need to be very careful" in trusting people scored 84.6% and 75.5% for the OIC and non-OIC countries respectively (with a global average of 76.3%). Furthermore, recent data on

corruption perceptions published by Transparency International (2020) shows that the average score of 56 OIC member countries was 33.27 on a scale of 0 (Highly Corrupt) to 100 (Very Clean). With the average of the top ten ranking countries score of 84.2, the score of the OIC member countries indicate prevalence of widespread corruption.

The data on trust and corruption indicates that overall ethical standing is relatively lower in Muslim countries compared to other countries which implies that entrepreneurs are not likely to abide by normative Islamic entrepreneurial ethics. The implication is that entrepreneurs are likely to be opportunistic, which will expose investors to moral hazard problems. While investors with Islamic financial ethics may be willing to absorb the losses arising from business risks, they will not accept unjust losses due to agency problems arising from entrepreneurial opportunism. In such cases, investors will attempt to mitigate agency problems contractually by using the four contractual tools (control rights, incentive structures, cash-flow rights and liquidation rights) identified above.

As discussed above, however, while control and incentive mechanisms can be used in the *musharakah* contract, normative Islamic financial rules impose restrictions on using preferential cash flows and liquidation rights to deal with agency problems (see Table 3). Since different classes of stocks cannot exist under Islamic financial ethical principles governing entrepreneurial finance, the investors cannot use the convertibility features to mitigate losses in case of exiting.

Although AAOIFI Sharia standards (Clause 3/1/5/4) allow the entrepreneur to voluntarily bear a disproportionate proportion of the losses compared to the capital share if both parties agree at the time of occurrence of the loss, it is not likely that an entrepreneur will opt to do this voluntarily. In such cases, the investors have to bear the losses of the venture as required by the maxims of "returns linked to risks."

Since the investors may not be willing to bear the losses arising from an entrepreneur's lack of normative Islamic ethics and Islamic financial ethics limit them to mitigate agency problems contractually, they may decide not to finance entrepreneurial ventures under these conditions. Thus, in the absence of entrepreneurial ethics, Islamic entrepreneurial finance may not be forthcoming since normative Islamic financial ethics impose restrictions on certain cash flow and liquidation rights that can help mitigate agency risks arising from opportunistic entrepreneurs.

5.3 Case 3: normative entrepreneurial and financial ethics not practiced

In the absence of normative Islamic entrepreneurial ethics, investors may attempt to mitigate agency risks arising from opportunistic entrepreneurs by securing the cash flow and liquidation rights contractually. One way in which this is operationalized in Islamic finance is to use a combination of contracts and stipulations that replicate the economic effects of conventional financial products. In entrepreneurial finance, this can be done by structuring transactions that create similar economic effects of convertible preferred stock so that the investors can transfer the risk of losses to the entrepreneur.

One option of doing this in Islamic finance is by using a "purchase undertaking", whereby the entrepreneur is obliged to purchase the shares of the investors at the time of liquidation at a price reflecting the investment value. The sale of the investor's shares to the entrepreneur at the time of liquidation creates a debt that must be paid after the sale of the venture. This structure ensures the investors get a disproportionate part of the sale

value while the entrepreneur bears the bulk of the losses. The practice of combining *musharakah* with a purchase undertaking creates similar economic effects of a convertible preferred stock, namely by shifting the risks of failure to the entrepreneur.

Although AAOIFI Sharia standards categorically prohibit preferred stocks, the above structure produces some of its economic effects and thus violates normative Islamic financial ethical principles. The stratagem of developing contractual structures that fulfil contractual forms but not the substance violates the maxim of "substance over form". The structure also contradicts the maxims of "returns linked to risks" that requires the owners of capital to bear the risks. The purchase undertaking transfers the risk of failure from investors to entrepreneur who bear the burden of the losses, thereby diluting Islamic financial ethics.

The above discussions show that when entrepreneurs are opportunistic, Islamic investors face the dilemma of either using *musharakah* and bearing the losses related to moral hazard problems or diluting Sharia principles to mitigate agency risks arising in entrepreneurial finance. Since normative Islamic financial ethics impose restrictions on certain cash-flow and liquidation rights that can be used to mitigate losses arising from agency problems, financing entrepreneurs will be possible by diluting the normative ethics of justice and risk sharing of a *musharakah* contract in substance. This dilemma highlights the fact that applying normative Islamic financial ethics presumes the presence of normative Islamic entrepreneurial ethics. In the absence of the latter, normative Islamic financial ethics are difficult to apply in practice.

6. Conclusion

Recognizing that agency problems arising in entrepreneurial finance can be resolved either ethically through building trust or legally through contracts, this article contributes to an under-researched area of Islamic ethics and entrepreneurial finance. While Islamic financial contracts in here ethical principles of fairness and justice that provide a fair allocation of risk and returns between the entrepreneur and the financiers, this comes at the cost of a loss of flexibility. This paper highlights the constraints that normative Islamic ethics impose on the flexibility of financial contracts and the conditions under which normative and positive ethics would complementary or contradictory.

The paper argues that the practice of normative Islamic entrepreneurial ethics can help mitigate agency problems, and investors will be able to use contracts reflecting Islamic financial ethics to invest in start-ups. In this ideal world, Islamic entrepreneurial ethics will mitigate information asymmetry problems and reduce the agency costs of contracting arising from financial relations. The use of Islamic contracts to finance enterprises would produce a just outcome in terms of the distribution of returns and risks for both the entrepreneur and investors.

When normative Islamic entrepreneurial ethics are absent, however, there will be a need to mitigate agency problems contractually. Unlike conventional instruments such as convertible preferred stock that have the freedom to include a variety of stipulations, Islamic legal and ethical principles impose constraints on the ways in which cash flow and liquidation rights can be distributed among parties. If investors are unable to mitigate agency risks contractually, then Islamic ethical principles will hinder entrepreneurial finance.

The implication is that in the absence of normative entrepreneurial ethics, entrepreneurial finance can take place by diluting some normative Islamic financial ethical principles to deal with agency problems. Thus, the ethical content of Islamic entrepreneurial finance will depend on the practice of normative entrepreneurial ethics. While the paper highlights the conditions that can lead to a lack of application of Islamic normative ethics in entrepreneurial finance, the conclusions are also applicable to and can explain the wider practice of Islamic finance that dilutes normative Islamic financial ethics by focusing on form over substance.

Notes

1. Karim, Tarazi, and Reille (2008) find that an estimated 72% of the people living in the Muslim world do not use formal financial services and a large percentage of the population in Muslim countries (ranging from 20% to more than 40%) would not avail conventional microfinance to avoid interest. Similarly, Demirguc-Kunt, Klapper, and Randall (2014, 198) find that 45% of 5,071 respondents from five Muslim countries would prefer expensive Islamic financing than an interest-based loan.
2. While the focus of this paper is on entrepreneurial finance, the literature on the broader topic of corporate finance from Islamic perspectives is also meagre. As in the case of entrepreneurial finance, the scant literature on Islamic corporate finance deals with contracts used in a corporate setup and the costs of capital. See Alzahrani (2019) for a review of articles that appeared in a special issue on Islamic finance in the *Journal of Corporate Finance*.
3. Historically, most traditional Islamic contracts were used in environments that assumed personal relationships in which parties knew and trusted each other. High levels of ethics and trust among parties make the use of traditional contracts such as *musharakah* possible without creating serious agency problems. For a discussion on how agency problems were mitigated in trade relations with little legal contract enforceability during the medieval times see Greif (1993).
4. Cumming and MacIntosh (2003) outline five possible exit routes that venture capitalists can opt for. *Issuance of public offerings (IPOs)* are a route in which the shares of the firm are sold to the public by listing them in the stock market. *Acquisition* is the private sale of the entire firm to some interested third party buyer. The buyer may be a strategic acquirer that has business in the same line of product and the payment can be in cash, assets, or shares in the acquirer company. In *secondary sale*, the venture capitalist sells its share in the firm to an outside acquirer while the entrepreneur and other investors retain their shares in the enterprise. In the *buyback* exit the entrepreneur purchases the shares of the investors. The *buyback* plan by the firm can be included in the investment contract so that the venture capitalist can always resort to this alternative if other alternatives do not materialize. Finally, the *write-off* option is used to offload a firm that does not perform well. In write-offs, the investors usually incur losses.
5. Kaplan and Stromberg (2003) find convertible preferred stock appearing in 204 of the 213 (95.7%) financing rounds by venture capital firms in the United States. While empirical studies show that venture capitalists in the United States prefer to use convertible preferred equity to finance new enterprises, studies from other countries show the use of other contractual forms such as common stock and different types of debt (Denis 2004; Cumming 2006). For a review of literature on the use of various contracts for entrepreneurial finance see Burchardt et al. (2016).
6. Smith (2004) classifies the study of law as historical, prescriptive, descriptive and interpretive. Normative ethics would take the form of prescriptive ethics, and positive ethics would be descriptive.

7. Trust is "faith or confidence that the other party will fulfill obligations set forth in an exchange", responsibility is "taking responsibility of one's actions", and commitment is "an implicit or explicit pledge to relational continuity between exchange partners" (Gundlach and Murphy 1993, 41–42). Gundlach and Murphy (1993) assert that responsibility and commitment can be subsumed as underlying moral traits that enhance trust.
8. The case when entrepreneurial ethics is practiced but financial ethics is absent is not relevant since agency problems are resolved on the entrepreneurial side ethically, although the financial institutions dilute the Islamic financial ethics.
9. Based on recognized reference in the Quran or *Sunnah*, the maxims evolved over a period of time to become general principles manifesting the essence of Sharia (Dien 2004, 113).
10. There is another dimension of ethics that is discussed in the literature related to the implications of Islamic principles on environmental, social and governance (ESG) related issues (see Hassan et al. 2021). The ESG related issues are not discussed since the focus of the paper is on agency issues arising in financing entrepreneurs.
11. The principle of permissibility is derived from maxims such as "permissibility is the original rule of things" or "the norm in transactions is that of permissibility" (Laldin et al. 2013, 10).
12. For a discussion on these modes of financing see Ayub (2007) and Usmani (1999).
13. See "AAOIFI Sharia Standard No. 12: Shirkah (Musharakah) and Modern Corporations" in AAOIFI (2015).

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