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Determinants of Profitability in Malaysia's Top 100 Shariah-Compliant Listed Firms

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Abstract

This study examines the determinants of profitability among 44 firms selected from the top 100 Shariah-compliant companies listed on Bursa Malaysia. Using panel data regression analysis, profitability measured by gross margin is analyzed against five independent variables: liquidity (quick ratio), leverage (assets to equity), efficiency (inventory turnover), earnings power (earnings retention), and corporate governance (highest remuneration and board compensation). The Random Effects Generalized Least Squares model with robust options was used to analyze the data. The results reveal that efficiency has a positive influence on profitability, indicating that effective inventory management enhances firm performance. Conversely, corporate governance, represented by the highest remuneration, shows a significant negative relationship with gross margin. This outcome underscores the importance of fair and equitable compensation practices in accordance with Shariah principles. The study acknowledges limitations related to sample size, limited financial indicators, and reliance on historical data from 1993 to 2023, which may not capture recent market developments.

Keywords: Shariah-Compliant Firms, Profitability, ESG Factors, Corporate Governance, Islamic Finance

Introduction

Profitability is a fundamental objective of all firms as it reflects the effectiveness of their operational and strategic decisions. For Shariah-compliant firms, profitability carries additional importance because all financial practices must align with Islamic principles that prohibit interest-based transactions and emphasize ethical investment (Usmani, 2002). Profitability also indicates a firm's financial strength, its ability to meet obligations without excessive reliance on debt, and its capacity to attract investors who value ethical financial conduct. The global development of Islamic finance has therefore intensified scholarly

interest in understanding what drives profitability among Shariah-compliant firms (Abdullah and Shen, 2017).

These firms operate within the principles of Islamic law which prohibit interest (riba), uncertainty (gharar), and gambling (maysir) (Usmani, 2002). Such restrictions require distinctive financial strategies that may influence the determinants of profitability differently compared to conventional firms (Iqbal and Mirakhor, 2011). This study focuses on 44 of the top 100 Shariah-compliant firms listed on Bursa Malaysia, identified through Refinitiv Eikon, to explore the factors that influence profitability (Hussain et al., 2015).

Previous research has highlighted several financial factors that may influence profitability, including firm size, leverage, liquidity, and efficiency (Ab Halim, Mohd Helmi, and Rashid, 2015). However, the influence of corporate governance, particularly remuneration policies, on profitability within Shariah-compliant firms remains relatively unexplored. This study aims to address this gap by examining how executive remuneration affects profitability. The research contributes to the literature by integrating corporate governance into the framework of profitability determinants within the Islamic finance context.

The paper is structured as follows. The next section reviews relevant literature, followed by an explanation of the research design, sample selection, and data analysis procedures. The subsequent sections present the findings, discussion, and concluding remarks, including study limitations and suggestions for future research.

Literature Review

Profitability is influenced by several key determinants, among which liquidity, leverage, efficiency, earnings power, and corporate governance are fundamental.

Liquidity impacts profitability as it reflects a firm's ability to cover its short-term obligations. High liquidity generally signals financial stability, enabling a firm to handle expenses without incurring debt, which can support profitability (Smith & Wang, 2019). However, excessively high liquidity may indicate that cash is not being used optimally for investments, potentially leading to reduced profitability as idle cash misses growth opportunities (Johnson, 2020).

Leverage, or the use of debt, also significantly influences profitability. Managed carefully, leverage provides companies with funds to expand and potentially increase profits, as well as offering tax benefits due to interest deductions (Brown, 2018). Conversely, excessive leverage can lead to increased financial risk, high-interest obligations, and reduced profitability, especially if market conditions shift unfavorably (Ahmed & Tan, 2021).Similarly, efficiency plays a pivotal role, as firms that manage resources and operations well often experience higher profitability. For instance, effective inventory turnover minimizes holding costs, while asset management maximizes revenue, enhancing profit margins (Jones & Gray, 2019). However, an intense focus on efficiency can sometimes backfire. If, for example, inventory is reduced too much to save on holding costs, it can lead to stockouts, potentially losing sales and hurting profitability (Singh, 2022).

Earnings power, or the firm's ability to generate retained earnings, enables self-financing for growth without depending on external debt. Strong earnings power enhances

profitability and is attractive to investors as it often indicates stability and growth potential (Abdullah & Lee, 2020). On the downside, retaining too much profit without reinvesting or distributing it as dividends can frustrate shareholders and limit profitable growth opportunities, which can stymie investor interest and lead to stagnation (Chen, 2021).

Lastly, corporate governance affects profitability by establishing practices that align management decisions with shareholder interests. Effective governance, such as balanced executive compensation and strong board oversight, helps reduce conflicts and ensure that management actions support long-term profitability (Khan & Rahim, 2021). However, weak governance, such as excessively high executive pay, can drain profits and lead to financial inefficiencies, impacting profitability negatively (Miller, 2020). Poor governance can also lead to ethical lapses that harm the company's reputation and financial performance (Lee & Patel, 2019).

In sum, while each of these factors—liquidity, leverage, efficiency, earnings power, and corporate governance—individually influences profitability, a balanced approach is essential to ensure sustained profitability and long-term growth.

Research Methodology

This section outlines the empirical research methodology applied in this study, with an emphasis on econometric techniques pertinent to panel data analysis. Specifically, the study utilizes static models derived from unbalanced panel datasets to investigate the overall influence on the relationship between profitability and its determinants. The sections below detail the research design, population and sample selection, data collection procedures, variable measurement, model specification, and estimation processes.

Research Design

This study adopts a quantitative descriptive design to analyze the influence of liquidity, efficiency, leverage, earnings power, and corporate governance on profitability among Shariah-compliant firms in Malaysia.

Population and Sample

The study focuses on the top 100 Shariah-compliant firms listed on Bursa Malaysia. These firms operate under Islamic principles across diverse industries.

Sample Selection

Financial and banking institutions were excluded because their capital structures differ significantly from those of non-financial firms. This exclusion follows previous studies that argue financial firms are subject to distinct regulatory frameworks such as the Banking and Financial Institutions Act (BAFIA) which influences their leverage capacity (Tew and Enylina, 2005; Ratshikuni, 2009). As presented on Table 1, after excluding financial firms and those with incomplete data, 44 firms were retained for analysis.

Table 1
Number of Firms in the Initial and Final Sample Firms

	No of firms
Number of firms in the initial samples	100
Number of financial firms / REITs / insurances	28
Number of firms with incomplete data	28
Number of firms in the final sample	44

Data Analysis Procedures

The data analysis process involves the following steps:

a. Model Selection: Based on Park (2011), three tests—the F-test, Breusch-Pagan Lagrange Multiplier (BP-LM) test, and Hausman test—are conducted to determine the optimal static panel data analysis approach.
b. Diagnostic Testing: Diagnostic tests identify potential issues such as multicollinearity, heteroscedasticity, or serial correlation.
c. Problem Rectification: Issues detected during diagnostic testing are addressed, following the recommendations of Hoechle (2007) for remedy procedures.

This methodology offers a structured approach for analysing the profitability determinants of Shariah-compliant firms, ensuring rigor and alignment with best practices in econometric modelling.

Findings and Discussion

The findings as presented below examines the determinants of profitability, measured by gross margin, and reveals key relationships between profitability and various independent financial indicators.

Model Fit and Statistical Significance: The constant term is positive and highly significant (0.3843, t = 3.53), indicating that other unobserved factors might contribute positively to profitability. The Chi-square test result (40.2269, $p < 0.001$) supports the model's overall significance, meaning that the predictors collectively influence profitability, albeit modestly as shown by the within and overall R-squared value (R2_o = 0.0537). This aligns with similar empirical studies in profitability determinants, where specific factors may be influential even if the overall model fit remains low (Gujarati, 2015).

Liquidity: The coefficient for liquidity is -0.0255, though statistically insignificant ($p > 0.05$, t = -0.93), indicating no strong association with gross margin. While liquidity is typically expected to support profitability by ensuring operational stability (La Rocca, 2017), this finding suggests that in this context, higher liquidity might not enhance profitability.

Leverage: Similar to liquidity, leverage has a negative but statistically insignificant coefficient (-0.0075, t = -0.32), implying that leverage does not have a strong impact on profitability. This aligns with research by Titman and Wessels (1988), who noted that while leverage can offer tax benefits, excessive reliance on debt may reduce financial flexibility and thus, profitability.

Efficiency: Efficiency shows a statistically significant positive relationship with gross margin (0.0002, t = 2.81, $p < 0.01$). This finding underscores the importance of operational

efficiency, as it appears to directly enhance profitability. Similar studies by Gschwandtner (2005) affirm that efficient asset use leads to better cost control and margin improvements.

Earnings Power: The earnings power variable has a positive coefficient (0.0249), but it is statistically insignificant (t = 0.60). Earnings power often represents a firm's capability to generate profits from its core activities, and while it shows a positive direction, the lack of statistical significance may suggest that other factors or a more extended analysis are needed for clearer insights (Voulgaris et al., 2005).

Corporate governance: Interestingly, Corporate governance, proxied by remuneration packages exhibit a highly significant negative relationship with gross margin (-0.0000, t = -3.66, p < 0.01). This suggests that higher remuneration costs could detract from gross margins, a finding consistent with Baumol's (1959) cost disease theory, where increased compensation without productivity gains may erode profitability.

Table 1
Determinants of Profitability

Liquidity	-0.0255
	(-0.93)
Leverage	-0.0075
	(-0.32)
Efficiency	0.0002***
	(2.81)
Earnings Power	0.0249
	(0.60)
Corporate Governance	-0.0000***
	(-3.66)
Constant	0.3843***
	(3.53)
N	77
R^2_w	0.0573
R^2_o	0.0537
Chi2	40.2269
p-value	0.0000

t statistics in parentheses

Conclusion, Limitations, and Suggestions for Future Research

This study examined the impact of liquidity, leverage, efficiency, earnings power, and corporate governance on profitability, as measured by gross margin. The findings indicate that efficiency and corporate governance are significant predictors of profitability. Efficiency positively impacts profitability, affirming that optimized operational processes enhance a firm's gross margin. In contrast, corporate governance (remuneration packages) have a negative impact on gross margin, suggesting that increased compensation costs may detract from profitability when not aligned with productivity gains. The results contribute to the literature by highlighting the nuanced relationships between financial determinants and profitability, with practical implications for financial management and cost control.

While this study provides valuable insights, it has several limitations. First, the use of gross margin as a sole profitability measure may not capture the complete financial performance of firms, as it excludes other important dimensions such as net profit margin and return on assets. Second, the relatively low R-squared values suggest that unobserved variables not included in the model could play a significant role in explaining profitability. Third, the dataset is limited to specific firms and industries, which may limit the generalizability of the findings. Lastly, this study did not account for external macroeconomic factors, such as market conditions or industry-specific trends, that may influence the relationship between the variables studied and profitability.

Future research could address these limitations by exploring additional measures of profitability, such as net profit margin or return on equity, to gain a more comprehensive understanding of firm performance. Expanding the sample to include firms from diverse industries and geographic locations may enhance the generalizability of the findings. Additionally, future studies could incorporate external macroeconomic factors to capture broader influences on profitability. Researchers could also investigate potential mediating or moderating variables, such as market competition or firm size, to uncover more complex dynamics in the determinants of profitability. Finally, longitudinal studies could provide insights into the long-term effects of these determinants on profitability, helping to identify trends and causal relationships over time.

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