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

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ABSTRACT

The study examines the determinants of profitability for 44 of the top 100 Shariah-compliant firms listed on the Bursa Malaysia. Using the panel data regression, it analyses the relationship between profitability (measured by gross margin) and five factors: liquidity (quick ratio), leverage (assets to equity), efficiency (inventory turnover), earning power (earnings retention), and corporate governance (highest remuneration and board compensation). The Random Effects Generalised Least Squares (GLS) regression with robust options revealed key insights. Efficiency, measured by inventory turnover, positively impacts profitability ($p < 0.05$), highlighting the benefits of effective inventory management. Notably, corporate governance, specifically the highest remuneration package, negatively correlates with profitability, suggesting that Shariah principles emphasising fair compensation play a role. However, the study has limitations. The small sample size affects generalisability, a limited selection of financial ratios results in lower adjusted R-squared values, and reliance on historical data (1993–2023) may not fully reflect current market testability.

Keywords: Corporate governance, ESG factors, Islamic finance, profitability, shariah-compliant firms

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INTRODUCTION

Profitability is a key indicator of a firm's success, reflecting its efficiency and growth potential. For Shariah-compliant firms, achieving profitability is more complex due to adherence to Islamic principles, which prohibit interest (riba), uncertainty (gharar), and gambling (maysir) while promoting ethical investment. Beyond financial stability, the profitability also enhances market valuation and attracts investors who prioritise Shariah-compliant business models (Abdullah & Shen, 2017). Unlike conventional firms, Shariah-compliant businesses operate under strict financial guidelines, presenting unique challenges. This study examines 44 of the top 100 Shariah-compliant firms listed on the Bursa Malaysia, using data from the Refinitiv Eikon, to identify key profitability drivers (Hussain et al., 2015). Previous studies (e.g., Halim et al., 2015) have highlighted factors such as firm size, leverage, liquidity, and operational efficiency. However, the impact of corporate governance particularly executive remuneration remains underexplored. This study addresses that gap by analysing the link between corporate governance and profitability in Shariah-compliant firms. The findings offer insights for investors, policymakers, and corporate leaders looking to optimise governance structures for long-term sustainability. A key contribution of this research is its focus on executive remuneration, specifically the highest compensation packages, as a determinant of profitability. By examining corporate governance from a Shariah-compliant perspective, this study provides new insights within the Malaysian context. The paper is structured as follows: first, it explores key determinants of profitability among Shariah-compliant firms in the Bursa Malaysia and outlines the methodology for data collection and analysis. The results section presents key findings, including regression outcomes and hypothesis testing. Finally, the paper discusses study limitations, practical recommendations, and future research directions.

DETERMINANTS OF CAPITAL STRUCTURE

Profitability is essential for a company's financial health. For Shariah-compliant firms in Bursa Malaysia's top 100, managing key factors like liquidity, leverage, efficiency, earnings power, and corporate governance is crucial. Liquidity ensures stability but holding too much cash can limit growth (Johnson, 2020). Leverage helps fund expansion but excessive debt raises financial risks (Ahmed & Tan, 2021; Brown, 2018). Efficiency boosts profit margins, though extreme cost-cutting can harm sales (Jones & Gray, 2019; Singh, 2022). Earnings power supports growth, but retaining too much profit may frustrate investors (Abdullah & Lee, 2020; Chen, 2021). Good corporate governance enhances financial performance, while excessive executive pay can weaken profitability (Khan & Rahim, 2021; Lee & Patel, 2019; Miller, 2020). Balancing these factors helps Shariah-compliant firms stay competitive while meeting ethical and financial constraints.

METHODOLOGY

This study examines the factors influencing profitability in Shariah-compliant firms using panel data analysis. A quantitative approach is used to analyse how liquidity, efficiency, leverage, earnings power, and corporate governance impact profitability. The focus is on the top 100 Shariah-compliant firms listed on the Bursa Malaysia, but financial institutions, banks, and insurance firms are excluded due to their unique financial structures and regulations (Chen, 2004). After filtering, 44 firms remain in the final sample. The data analysis follows three main steps. First, model selection is conducted using tests like the F-test, Breusch-Pagan Lagrange Multiplier (BP-LM), and Hausman test (Park, 2011). Second, diagnostic tests check for issues such as multicollinearity, heteroscedasticity, and serial correlation. Lastly, any identified issues are corrected following Hoechle's (2007) recommendations. This structured approach ensures accurate analysis of profitability factors in Shariah-compliant firms.

FINDINGS AND DISCUSSION

The model is statistically significant. However, the overall model fit is modest ($R^2 = 0.0537$), which aligns with prior research indicating that while some factors impact profitability, their combined effect may be limited (Gujarati, 2015). Liquidity has a negative but statistically insignificant impact on gross margin. This suggests that while liquidity ensures operational stability, it does not necessarily enhance profitability in this context (Rocca, 2017). Similarly, leverage also shows a negative but insignificant effect, supporting the view that while debt can offer tax benefits, excessive reliance may reduce financial flexibility and profitability. Efficiency, however, has a significant positive effect, reinforcing that better resource management improves cost control and profit margins. Earnings power shows a positive relationship with profitability, though it is statistically insignificant, indicating that further analysis may be needed to clarify its impact. Corporate governance, measured through remuneration, has a highly significant negative effect, suggesting that excessive executive compensation may erode profitability.

CONCLUSION

This study examines how liquidity, leverage, efficiency, earnings power, and corporate governance affect profitability, measured by gross margin. The results show that efficiency improves profitability, while high remuneration costs reduce it. This highlights the importance of cost control and operational efficiency in financial performance. However, the study has limitations. Gross margin alone may not fully reflect profitability, and other unexamined factors could influence results. The focus on specific firms and industries also limits generalisability, and external factors like market conditions were not considered. Future research should include broader profitability measures, diverse industries, and macroeconomic factors for a more complete analysis. Examining competition, firm size, and long-term trends could also provide deeper insights into profitability drivers.

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