Performance of Shari'ah-compliant and non-Shari'ah-compliant listed firms: a case study of Malaysia

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Abstract

Purpose – Shari'ah provides the basic tenets of the Islamic finance industry and advocates banks to share their profits and losses with investors. But what it means for a firm to be "Shari'ah-compliant" and what form of connections it can have, even in theory, to either the firm's value or profitability is still an untapped question. This study tries to answer this question. This study aims to find the impact of Shari'ah compliance on firm performance. The results obtained would be useful in helping investors, regulators, companies, government, academicians and practitioners in their decision-making process as to ensure better economic and business gains, both locally and globally.

Design/methodology/approach – Panel data on 634 Shari'ah-compliant firms have been used in this study for the period of 2000–2014.

Findings – The results indicate that Shari'ah compliance adds to the value of firms as firms perform transactions according to Shari'ah while avoiding non-permissible activities.

Originality/value – This study adds value to the existing literature by showing the statistical results for the impact of Shari'ah compliance on the performance of the listed firms on Bursa Malaysia.

Keywords Malaysia, Islamic finance, Shari'ah compliance, Listed companies, ROA

Paper type Research paper

1. Introduction

Islam focuses on the economic system to create social justice as well as economic well-being of the society. This fulfils the criteria defined in *Maqasid al* Shari'ah (Shari'ah objectives). Accordingly, Islamic finance does not involve in *Riba* (interest), *Gharar* (ambiguities) and *Maysir* (gambling), and provides a framework based on the values of human welfare. Governments and Shari'ah scholars of Malaysia, Iran, Pakistan and Sudan have provided tacit support for Islamic finance businesses and services in their countries (Henry and Wilson, 2004). Given that Islamic economics, which includes Islamic Banking and Finance (IBF), is built on the principles and guidance of the Holy Quran and Sunnah by negating

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interest and focusing on real assets and real economy, IBF is rapidly emerging across the globe and is gaining appreciation by people of all faiths (Chachi, 2006).

Various literature (Quttainah, 2012; Abdul Karim *et al.*, 2013; Ho *et al.*, 2014) claim that Islamic finance is distinct from traditional finance both in terms of its business conduct and values. The values that guide the operations of Islamic finance are within the ambit of Shari'ah and assist in the realisation of the objectives (*Maqasid*) *of* Shari'ah. The term Shari'ah means a path to be followed and encompasses personal as well as religious codes. *Maqasid al* Shari'ah echoes the all-inclusive interpretation of Islam, and appreciation of these objectives is vital for the achievement of economic prosperity, brotherhood, social welfare and justice in the society. In its entirety, maximisation of profit is not the primary objective in an Islamic society. Increase in wealth should be escorted with the consciousness of mind, fairness and transparent play at all levels of society. The development of such form of caring society is in harmonisation with the achievement of *Maqasid al* Shari'ah (Choudhury, 2000).

Islamic finance is not a new concept/subject. Its practices began in the first-ever Muslim State in Medina which was established by the Holy Prophet PBUH. Modern Islamic finance, however, is believed to have informally started in the 1950s from a small village in Pakistan and more formally in Egypt. In 1973, Mit Ghammar Bank started its operation on a grander scale in Egypt, while in 1975, Dubai Islamic Bank was the second in the Islamic world but the first in the UAE. In 1969, Malaysia introduced Islamic finance and now holds a leading position in the Islamic financial world. As at end of 2017, the Islamic finance industry in Malaysia comprises Islamic banking (24.9% of total banking industry), takaful (15.2% of the total insurance sector), sukuk (46.9% of sukuk outstanding) and Islamic funds (32% of global Islamic funds domiciled in Malaysia)[1]. The topic of research in this study revolves around the Islamic capital market which makes up 59.56% of the overall Malaysian capital market, and specifically the equity market. With the implementation of Islamic Financial Services Act (IFSA) 2013 and launch of value-based intermediation (VBI) 2018, Malaysia continued top position in Islamic finance worldwide. People, profit and planet are the three pillars of VBI[2]. Role of people is important in terms of implementation of Shari'ah rules in firms to attain Shari'ah compliance status as prescribed by the Shari'ah supervisory authority known as Advisory Council (SAC) of Securities Commission Malaysia.

Previous research has mainly focused on profitability (Azad *et al.*, 2019; Yanikkaya *et al.*, 2018), efficiency (Safiullah and Shamsuddin, 2019; Beck *et al.*, 2013), stability (Albaity *et al.*, 2019; Čihák and Hesse, 2010), diversification and risk management (Hassan *et al.*, 2019; Ibrahim and Rizvi, 2018; Abedifar *et al.*, 2013) of Islamic banks. Recently, Islamic firms are the focus of literature, more specifically, assessing the determinants of performance (Ho and Mohd-Raff, 2019; Farooq and Alahkam, 2016), earning management behaviour (Farooq and AbdelBari, 2015), corporate social responsibility and firm's profitability (Azam *et al.*, 2019) and coporate governance (Hayat and Hassan, 2017).

Islamic firms are different from its counterpart at least in two ways. First, they have to follow to business-screening criteria and are prohibited to conduct businesses such as alcohol and entertainment industry. Second, their operations also have to adhere to financial screening[3].These distinctive features of Islamic firms might reflect different behaviour as compared to conventional firms. Therefore, the main purpose of this study is to assess the comparative performance of Shari'ah and non-Shari'ah compliance firms in Malaysia for the period 2000–2013. Following previous literature (Farooq and Alahkam, 2016; Ho and Mohd-Raff, 2019), we incorporate the return on equity (ROE), return of assets (ROA) and growth of total assets as measure of firm's performance.

2. Development of Islamic finance in Malaysia

Over the past three decades, Malaysia has built a strong and resilient Islamic financial industry with solid foundation in regulations and knowledge. IFSA adds to this unique and well-designed Islamic financial framework and covers two-pronged supervisory goals, with financial stability and compliance with Shari'ah as the principal focus.

In Malaysia, the capital market development started after the 1997–1998 currency crisis. Malaysia has gained popularity as the only country in the world where regulators brought Shari'ah compliance on all fronts including in the capital market. This provides the rationale on why Malaysia has Shari'ah-compliant equivalents of equity, debt/bond, interbank, derivatives and other capital market instruments. The Securities Commission (SC) was established in 1995 after merging six different regulators into one, to establish the Islamic capital market under the watchful eyes of the SAC in 1996. At the same time, the Islamic Capital Market Division was also established at SC [4].

The Shari'ah screening process for the listed companies of Malaysia started in 1995 and the first list of Shari'ah-compliant stocks/securities was published on Bursa Malaysia in 1997. From 1998, the list of Shari'ah-compliant securities was announced twice in a year. In 1999, Bursa Malaysia launched the first Kuala Lumpur Shari'ah Index. In 2004, the Securities Commission shared the benchmarks used for the screening of Shari'ah-compliant securities. Three years later, in 2007, the publishing of Shari'ah-compliant stocks' list was shifted to May and November of each year from April and October.

The old methodology of Shari'ah screening was based on the computation of non-permissible activities and comparison with group revenue and group profit before tax using 5%, 10%, 20% and 25% benchmark for quantitative analysis. For qualitative screening, public perception and *Maslahah* was used. The revised Shari'ah screening methodology was launched in 2013 and the list of Shari'ah-compliant firms used in this study are screened using the new methodology. A summary of the Shari'ah compliance securities on Bursa Malaysia is provided in Appendix 2. As of June 2016, 74.23% of the total securities listed on Bursa Malaysia are Shari'ah compliant.

This change of Shari'ah screening process is aligned with the SC's initiative to extend the global outreach of the domestic Islamic capital market, as delineated in the Capital Market Master Plan 2. This step has taken the Malaysian Islamic capital market to greater heights, reflecting the proactive strategy to continuously improve the system within the growing erudition of the industry, as well as to entice wider investor base into its market (MIFC, 2013).

Earlier studies showed that firms that are Shari'ah compliant adhere strictly to the Shari'ah rules which should lead to better performance and less governance issues (Haron and Ibrahim, 2012; Ashraf and Mohammad, 2014; Kr and Fu, 2014). A listed company in Malaysia has several costs and benefits for being Shari'ah compliant. First, to be classified as Shari'ah compliant, it must eliminate, or at least minimise the income contribution of all un-Islamic activities as prescribed by the SAC and SC screening criteria. Thus, it cannot gain (significant) revenue from interest-based financing, penalty payments of post-paid services offered, selling of non-halal food or alcoholic drinks (e.g. for restaurants) and provision of certain impermissible modern entertainments or gambling (e.g. for hotels, casinos). Second, its financing and investment options are also limited to only riba-free and Shari'ah-compliant instruments. Third, many firms (financial institutions) also need to hire the services of a Shari'ah committee or an advisor to help screen their products. IFIs, for example, also need to perform Shari'ah audits of their activities. All of these add to the operating costs of the firm. Additionally, the level of debt they can accumulate from interest-based sources is limited to less than 33%, which means they must avail equity or Shari'ah-

compliant financing such as *Musharakah*. Finally, they must invest in building a reputation of serving the community and being in line with Islamic teachings.

However, a firm listed as Shari'ah compliant in Malaysia has the advantage of being open to all investors looking for ethical or Islamic investments, including the Islamic equity indices, takaful funds, Islamic unit trust funds and Islamic stockbrokers. Shari'ah compliance also results in a higher level of disclosure and transparency within the organisation. In addition, apart from faith-based (Muslim) investors/customers in Malaysia, Shari'ah-complaint firms also attract ethical investors both from domestic and abroad. It can thus be argued that having less interest-based debt on financial statements may lead to the firm being less leveraged and less fragile, and in some cases, with even better profitability.

Shari'ah-compliant firms differ from their conventional counterparts as they focus on protecting the interests of all stakeholders (including their shareholders), and not just on maximising shareholder value. These firms have dual responsibilities, which are to satisfy the SAC's criteria of Shari'ah-compliant firms and to fulfil the expectations of various stakeholders. Arguably, Shari'ah-compliant financial institutions also face less exposure to speculative instruments such as financial derivatives because of the governing Shari'ah regulations. Ensuring Shari'ah compliance also includes extra costs of hiring Shari'ah members, Shari'ah audit team and Shari'ah compliance team. Investment opportunities are also limited to only Shari'ah-compliant investments, as compared to non-Shari'ah compliant companies that can invest without such restriction.

3. Research focus and related literature

Shari'ah provides the basic tenets of the Islamic financial system. It provides a detailed business environment manifested by ethically oriented trade, sustainable economic development and well-regulated financial systems. The latter forbids interest rates on providing loans or financing to households and on investments. Investments in businesses which are *haram* such as alcohol, pork products and ammunition are prohibited. Shari'ah also does not allow investments in businesses which involve speculation and unnecessary higher risks. IFIs are, however, encouraged to share their profits and losses with shareholders. Additionally, Islamic finance advocates the use of real assets security and equity participation, and investments are limited to Shari'ah-compliant assets. The use of ethical rules along with higher degree of carefulness in Islamic modes of financing makes investment a promising substitute for better quality performance, specifically in tempestuous times with extraordinary conventional financial risks (Jawadi *et al.*, 2014).

Islamic finance has shown strong resilience during all financial crises (Iqbal and Mirakhor, 2014) and has proved that it is the only viable alternative to conventional banking and finance (Siddiqui, 2010). The recurrent financial crises have placed the conventional financial world (interest based) under strict scrutiny. Some scholars are attempting to fix the inherent instability of conventional finance, whereas others are searching for possible alternative financial systems, which have led them to the Islamic financial system that is deemed to be offering financial stability and resilience (Ibrahim and Mirakhor, 2014). Alam (2009) analysed the performance of Shari'ah-compliant equities by constructing three portfolios of the overall 350 companies, by dividing them according to Shari'ah-compliant and non-compliant equities based on Standard and Poor's (S&P). He observed that Shari'ah-compliant equities outperform the non-compliant equities in every aspect. Based on the results, Alam concluded that Islamic finance can indeed withstand the turbulence of a financial crisis. This paper focuses on analysing the impact of Shari'ah compliance on the operations/performance of listed firms in the case of Malaysia. The sample size used in this research is bigger as compared to the sample used by Alam (2009). Also, the impact of

Shari'ah compliance on listed firms in Malaysia will help investors and regulators for the investment and regulation framework.

The rudimentary specific feature of an entity's target is to earn profit. Firms with strong corporate governance are expected to generate or earn more profits from their investments (Aswadi *et al.*, 2009; Gupta, Kennedy and Weaver, 2009) because of higher level of transparency and accountability. It is a norm for investors in primary/secondary markets to expect higher investment returns from companies with good governance as it is an indication of the companies' transparency and honesty. The study of 100 largest firms by Gill (2001) in the emerging markets showed a positive correlation between good corporate governance practices such as transparency, independence and fairness with firm performance. Azeem *et al.* (2015) conducted a longitudinal study before and after financial crises and concluded that corporate governance has no impact on firm performance in Pakistan, whereas Sami *et al.* (2011) analysed 1,236 firms and found that there is positive effect of good corporate governance practices on firm value (FV) in China. Strong corporate governance is expected to boost performance of firms and maximise their returns, whereas weak governance tolerates misuse of firms' resources by managers. The disclosures of financing mechanism/sources, ownership identity (control) and ownership structures also help in improving the performance of firms. The agency theory advocates shareholder value (stronger shareholders' rights, legal protection contrivance) focuses on the monitoring (in terms of compliance to rules, regulations, disclosures and transparent working) (Yoo and Jung, 2015) to correct the unethical/inappropriate behaviours of management, and thus, as a result, improves performance.

As discussed earlier, a firm's main objective is to maximise profit and/or minimise cost and would try to minimise risks associated with operational and financial decisions. Gaining bigger market shares with strong presence in the industry is also one of the important goals for some firms. Shari'ah-based firms work on the principle of profit/loss sharing. According to the rules of Shari'ah, Shari'ah-compliant firms cannot indulge in activities or transactions related to gambling, interest, speculation and other non-halal activities. It is a possibility that Shari'ah-compliant firms do earn less profit in comparison to non-compliant firms. However, Shari'ah-compliant firms should be contented as they conduct their businesses as per the principles of Islam/Shari'ah which protect the interest of society at large, thus enabling them to fulfil their social responsibilities. For example, non-compliant firms might externalise pollution costs, whereas Shari'ah-compliant firms would internalise such costs as part of their social responsibilities in accordance with *Maqasid al* Shari'ah. The performance of a firm is measured in different ways and the ones which are widely used are ROA and ROE (to measure profitability performance), as used in this study. Growth is also used as proxy to analyse the performance of a firm. In most of the studies mentioned above, the firm-specific variables used are ROA, ROE, growth, leverage, size and tangibility, and the macroeconomic variables used are GDP, interest rate and inflation rate to identify their impact on the profitability of the listed firms.

FV is an economic measure of the total market value of a given company. A simple way of understanding the concept of FV is to envision purchasing the whole firm. Enterprise value includes common shareholders' equity (at market value), market value of long-term and short-term debts, preference shareholders' equity (at market value) and any minority interest, unfunded pension liabilities, etc. Price–earnings ratio is commonly used for valuation of firms, especially when different firms are compared. However, this measure is significantly volatile when firms with very diverse capital structures are taken, as it is affected by the leverage of the firm.

Financial managers are always interested in all factors which affect or influence the FV, such as long-term debt or leverage, cost of capital, corporate governance measures, recent mergers, size of shareholders' equity and, in our context, even political linkages or *Shari'ah* compliance. Because one of the key objectives of a firm in the competitive corporate environment is maximising shareholders' value, measuring and comparing FV is of critical importance. After all, the value of the firm's equity as well as its market value, longevity, goodwill, etc. is part and parcel of the "wealth" of its shareholders. It can be argued in simple terms that:

$$\text{Value of a Firm's Assets} = \text{Value of Debt} + \text{Value of Equity}$$

In some The Organisation of Islamic Cooperation countries with growing Islamic financial industries such as UAE, Bahrain and Malaysia, there is now a significant attention given to the Shari'ah compliance of listed firms. Even in Pakistan, its Securities Commission in 2016 issued a 2% tax cut for all listed firms that were classified as Shari'ah compliant.

But what does it mean for a firm to be "Shari'ah compliant", and what connections can it form, even in theory, to either the FV or profitability? First, Shari'ah compliance means that a listed corporation is not earning its income (or a major part of it) in an industry classified as *haram* by Islamic law. Such industries include gambling and casinos, alcohol, pork and related products, tobacco, pornography and certain forms of entertainment, as well as interest-based financial institutions and insurance firms. Second, *Shari'ah* compliance requires certain restrictions on the company's financing and financial ratios, e.g. only a small percentage of the firm's total financing can be financed by (interest-based) debt, as interest is prohibited by *Shari'ah*. Third, certain *Shari'ah*-compliant financial firms, such as Islamic banks, Islamic asset management firms and takaful operators are also required to have a different Shari'ah corporate governance framework in place, which includes the involvement of Shari'ah experts (commonly termed *Shari'ah* advisors). Hence, it can be argued that, broadly speaking, a list of Shari'ah-compliant firms will not only exclude (or at least under-represent) certain industries, but may also be slightly less leveraged than others, and differ in their corporate governance practices.

The recurrent financial crises in the world have put Shari'ah-compliant finance into the limelight and Islamic finance is considered as a viable financial system when compared with conventional financial system. Academicians (Alam, 2009; Beck *et al.*, 2013; Hazzi, 2013) started to look into Islamic finance to see whether or not it is more stable than the conventional financial system. Alzalabani and Nair (2013) investigated the capacity of Islamic banks to withstand the financial crisis by studying Al Rajhi Bank in Kingdom of Saudi Arabia (KSA). They found that Islamic banks were more resilient to severity in comparison with the conventional banks. The soundness of Islamic banks has been linked to the deposits rather than funding through borrowings from the wholesale market. However, Islamic banks are not immune to the financial crisis. For example, low oil prices can impact negatively on the performance of Islamic banks in the Gulf region.

Setiawan and Oktariza (2013) conducted a study for the period of 2009–2011 to find out the risk and return profile differences between conventional and Shari'ah stocks in the performance of public listed companies of Indonesia. The result showed that the risk-adjusted returns of both samples performed in the same fashion. There were no significant differences in the standard deviation and beta of both conventional and Islamic stocks.

Jamal *et al.* (2010) did a conceptual study and discussed the issues related to Islamic capital market and the solutions provided by the screening process of SAC. The conclusion

was that the Shari'ah screening process of SAC helped SC to facilitate and develop many products for the effect conscription of Islamic funds.

Kr and Fu (2014) studied the performance of conventional stocks and Shari'ah-compliant stocks listed on the Australian stock exchange for the period 2001–2013. In terms of risks, there were significant differences between Islamic and conventional stocks, whereas in terms of performance, Islamic and conventional stocks performed in the same manner. The relationship between Shari'ah-compliant and conventional stocks returns was found to be statistically significant.

Ho *et al.* (2014) did an empirical study by comparing the risk-adjusted performance of share indices of both conventional and Islamic capital markets. The Islamic indices performed better than the conventional indices during the crisis period, but during non-crisis period, the results were mixed or indecisive. The Islamic investments outperformed conventional because of the conservative nature of Shari'ah compliance and it helped investors during crisis.

The studies above show that research is being conducted to investigate the capability of both conventional and Islamic banks to withstand the shocks of financial crisis by comparing their performance. However, studies on the overall performance of listed Shari'ah-compliant firms as compared to the aggregate (which include both financial and non-financial industries) in the Malaysian context are scarce.

This study will analyse the performance of firms in terms of their stability, performance and growth in Malaysia over the past decade. This analysis will help in ascertaining the position of Shari'ah-compliant firms, i.e. whether these firms really perform better and are more stable than non-compliant firms or not. Malaysia is particularly suited for this study, given its leading position in Islamic finance (see Appendix 1).

Shari'ah provides clear guidance for politics, economy and finance in an Islamic system. In this regard, Shari'ah-compliant firms should not be facing problems of agency, moral hazards and adverse selection as these are contrary to *Maqasid al* Shari'ah. If Shari'ah-compliant firms strictly adhere to the Shari'ah, then Shari'ah compliance should add to the firms' value and these firms should perform better than their non-compliant counterparts.

This study can help investors, regulators, companies, government, academicians and practitioners in future decision-making to ensure better economic and business growth, locally and globally. The main purpose of this research is to find the impact of Shari'ah compliance on firm performance with the following hypothesis:

H1. Being Shari'ah compliant impacts firm performance.

H2. Shari'ah compliance impacts firm performance positively.

4. Data and methodology

4.1 Data

For this study, we collect the data of all firms listed on Bursa Malaysia from DataStream and Securities Commission Malaysia for the period of 2000–2013, which is chosen based on the availability of data. To ensure the validity and robustness of analysis, we eliminate firms which do not have the data available and delisted form Bursa Malaysia within the period under scrutiny. The filters like removal of firms without complete data yield us unbalance data total of 941 listed firms with 634 firms have been identifies as Shari'ah compliant firms and 307 firms as non-Shari'ah compliant firms. Following Beck *et al.* (2013), we include those firms which have at least two observations. To mitigate the potential effect of outliers, we winsorise all the firm-specific variables at 1st and 99th percentile. To ensure

the status of a firm being Shari'ah compliant, we double check the firms on Securities Commission Malaysia to be Shari'ah compliant.

4.2 Target variables

4.2.1 Dependent variables. The main objective of this study is investigating the comparative performance of Shari'ah- and non-Shari'ah-compliant firms. Following previous literature (Ho and Mohd-Raff, 2019; Farooq and Alahkam, 2016; Safarova, 2010), we use the following proxy variables of firm performance:

Return on assets (ROA): The ROA is used to measure firm performance by most scholars. It is measured by dividing the earnings of firms before interest and tax by total assets. This provides an indication of how efficiently and effectively assets are used to generate profits, as higher ROA means higher earnings.

ROE: The ROE is defined as net profit to shareholders' equity.

Growth: Growth of the firm is measured as the annual increase in total assets.

4.2.2 Explanatory variables. Size: It is measured as the log of firm's total assets. The size of a firm is considered important for its profits. Research shows that bigger firms have more access to capital and have more profitable business. However, size and profits are negatively related because of inefficient management and diseconomies of scale. Jensen and Meckling (1976) concluded that the larger the firm size, the higher the agency cost with lower profits.

Capital expenditure (Capexp): It is measured as the log of firm's total assets. Firms with high level of capital expenditure reflect the growth of the firms in the long run.

Leverage: Leverage is measured as a ratio of total debt to total assets (Ebrahim *et al.*, 2014). Liquidity is an important area to understand the business approach of a firm. Firms with more liquidity have more investment options.

Tangibility (TATA): Tangibility is equivalent to tangible assets-to-total assets. Increased holding of tangible assets lowers the risk of lenders in having issues of agency costs of debt. Firms with higher levels of tangible assets are more prone to have higher debt.

Market value to book value (MTBV): It is market-based variable of firm's valuation and measure as market-to-book value of equity of firm. A firm is perceived to be valuable and more profitable if the value of MTBV is greater than 1 and vice versa.

Shari'ah *compliance*: Shari'ah compliance is measured according to the criteria prescribed by the SAC of SC. The SAC defines a firm Shari'ah compliant if the firm is in line with the criterion mentioned by the SAC. The SAC adopts a two-tier quantitative criterion in finding out the Shari'ah status of the listed securities. This would have an impact on the firm's operations in terms of increasing its profits as the firm is not involved in *haram* activities. The dummy variable is 1 if the firm is *Shari'ah* compliant and 0 otherwise.

Macroeconomic variables: To control for country-specific variable, we include gross domestic product (GDP), inflation and interest rate which can possibly affect the performance of firms.

Panel data is used in this study because it has both cross sections and time series levels. Panel data sets are also most useful in controlling time-constant unobserved features of firms, which might be correlated with the explanatory variables of the model.

4.2.3 Descriptive statistics. Table 1 presents the descriptive statistics of our data. The result shows that Shari'ah-compliant firms are more profitable with mean value of ROE and ROA 4.44 and 4.08, respectively. Further, Shari'ah-compliant firms exhibit high growth with mean value of growth of total asset 8.48. Firms, working under the umbrella of Islamic finance, are strictly required to be involved in real economic activities and prohibit them to take excessive risk. Further, non-Shari'ah-compliant firms are larger in size and have more

Variable	Panel A: All firms shariah compliant firms Obs	Mean	Std. dev.	Min	Max	Panel B: Shari'ah-compliant firms Obs	Mean	Std. dev.	Panel C: Non-Shari'ah-compliant firms Obs	Mean	Std. dev.
ROE	10,662	4.39	17.75	−79.60	58.53	7,522	4.44	17.02	3,140	4.28	19.40
ROA	10,662	3.85	9.17	−35.65	31.19	7,522	4.08	8.69	3,140	3.29	10.22
Growth	9,716	8.40	26.22	−47.61	158.53	6,837	8.48	25.70	2,879	8.19	27.44
Size	10,415	12.62	1.62	9.24	17.82	7,334	12.46	1.45	3,081	12.99	1.91
log_Capexp	10,162	8.57	2.20	2.64	14.15	7,196	8.54	2.14	2,966	8.62	2.35
Leverage	10,396	21.51	21.75	0.00	134.73	7,324	19.75	18.58	3,072	25.69	27.44
TATA	10,407	0.36	0.23	0.00	0.93	7,342	0.37	0.22	3,065	0.33	0.24
MTBV	9,667	1.15	1.13	−0.36	7.69	6,932	1.12	1.07	2,735	1.25	1.28
GDP	10,662	5.01	2.47	−1.51	8.86						
Inflation	10,662	2.24	1.24	0.58	5.44						
Interest Rate	10,662	5.79	0.86	4.61	7.67						

Table 1.
Descriptive statistics

capital expenditure, whereas Shari'ah-compliant firms have lower level of debt in their capital structure and are perceived as more valuable by market.

4.3 Methodology

To examine the comparative performance of Shari'ah- and non-Shari'ah-compliant firms and their determinants in multivariate analysis, I specify following panel model:

$$Y_{it} = \alpha_i + +\beta_1 Size_{it} + \beta_2 Capexp_{it} + \beta_3 Leverage_{it} + \beta_4 TATA_{it} + \beta_5 MTBV_{it} + \beta_6 ME_{it} + \varepsilon_{it} \quad (1)$$

whereas Y_{it} represents the alternative dependent varibel of performance of firm i in time t. Size, Capexp, Leverage, TATA and MTBV are the main explanatory variables. ME is the vector of country-specific variables which include GDP, inflation and interest rate. We estimate equation (1) using pooled ordinary least square (OLS), fixed effect (FE) and random effect (RE) which are widely used in the literature (Mitchell and Joseph, 2010; Bliss and Gul, 2012a, 2012b; Chen *et al.*, 2013; Muttakin *et al.*, 2015).

5. Results

Tables 2–4 present the results from OLS, FE and RE approach. The results show that Shari'ah compliance has a significant impact on the performance of firms, which means that the ROA, ROE and growth of firms which are Shari'ah compliant are better than that of non-Shari'ah-compliant firms. Size, Capexp and MTBV have statistically significant relationship with profitability of Shari'ah-compliant firms, which implies that firms larger in size and spend more in capital expenditure are more profitable and have positive sentiment from the market, whereas non-Shari'ah-compliant firms exhibit the positive relationship of ROA and MTBV. Moreover, shairah compliant firms are more sensitive to leverage in Capital structure which negatively impact the profitability of firms. However, this relationship is less pronounced for non-Shari'ah-compliant firms. Thus, Shari'ah compliance impacts the ROA, ROE and growth of listed firms in Malaysia positively[5]. This is an explanation as to

Table 2.
Determinants of firm performance (OLS approach)

Variables	All firms			Shari'ah-compliant firms			Non-Shari'ah-compliant firms		
	ROE	ROA	Growth	ROE	ROA	Growth	ROE	ROA	Growth
Size	0.83*** (0.153)	0.12 (0.074)	−0.29 (0.234)	0.80*** (0.196)	0.19** (0.097)	−0.71** (0.309)	1.05*** (0.263)	0.17 (0.123)	0.42 (0.380)
Capexp	1.85*** (0.111)	1.03*** (0.054)	2.05*** (0.169)	2.07*** (0.132)	1.12*** (0.065)	2.27*** (0.207)	1.39*** (0.213)	0.75*** (0.099)	1.56*** (0.307)
Leverage	−0.22*** (0.009)	−0.10*** (0.004)	−0.05*** (0.014)	−0.20*** (0.011)	−0.11*** (0.005)	−0.06*** (0.017)	−0.23*** (0.017)	−0.07*** (0.008)	−0.04* (0.024)
TATA	−1.30 (0.792)	0.72* (0.383)	−0.79 (1.205)	−1.63* (0.923)	0.25 (0.456)	−0.99 (1.453)	−0.00 (1.532)	1.47** (0.714)	−0.98 (2.199)
MTBV	1.92*** (0.156)	1.43*** (0.075)	1.34*** (0.240)	0.59*** (0.191)	0.96*** (0.094)	2.03*** (0.306)	4.15*** (0.273)	2.27*** (0.127)	0.20 (0.392)
GDP	1.16 (1.364)	0.99 (0.660)	1.04 (2.070)	0.44 (1.560)	0.71 (0.771)	0.34 (2.452)	2.76 (2.700)	1.64 (1.259)	2.62 (3.854)
Inflation	1.17* (0.642)	0.84*** (0.311)	1.24 (0.977)	1.23* (0.733)	0.98*** (0.362)	1.08 (1.152)	0.93 (1.279)	0.46 (0.596)	1.58 (1.841)
Interest rate	−2.36 (1.676)	−1.42* (0.812)	−1.30 (2.573)	−1.00 (1.920)	−0.83 (0.948)	−0.36 (3.059)	−4.91 (3.313)	−2.49 (1.545)	−3.58 (4.758)
Constant	−16.91*** (2.769)	−6.88*** (1.341)	−8.35* (4.313)	−20.03*** (3.285)	−9.43*** (1.623)	−6.09 (5.305)	−14.21*** (5.272)	−4.30* (2.459)	−10.15 (7.679)
Observations	9,321	9,321	9,016	6,703	6,703	6,470	2,618	2,618	2,546
R-squared	0.15	0.17	0.04	0.14	0.17	0.05	0.21	0.20	0.04
Number of firms	872	872	872	621	621	621	251	251	251

Notes: Standard error is reported in parentheses. Significance codes: ***statistical significance at 1, **5 and *10%, respectively

Table 3. Determinants of firm performance (OLS approach)

Variables	All firms			Shari'ah-compliant firms		
	ROE	ROA	Growth	ROE	ROA	Growth
Size	1.86*** (0.455)	1.78*** (0.208)	12.49*** (0.751)	1.14** (0.534)	1.52*** (0.253)	11.25*** (0.898)
log_Capexp	1.16*** (0.148)	0.45*** (0.068)	1.80*** (0.242)	1.23*** (0.176)	0.54*** (0.083)	2.07*** (0.290)
Leverage	−0.28*** (0.013)	−0.14*** (0.006)	−0.17*** (0.022)	−0.24*** (0.015)	−0.14*** (0.007)	−0.16*** (0.026)
TATA	2.15** (0.992)	0.91** (0.454)	3.38** (1.608)	1.23 (1.168)	0.76 (0.553)	4.24** (1.925)
MTBV	0.04 (0.209)	0.83*** (0.096)	1.01*** (0.347)	−0.73*** (0.245)	0.64*** (0.116)	1.38*** (0.414)
GDP	1.23 (1.234)	1.02* (0.564)	1.48 (1.994)	0.43 (1.438)	0.80 (0.681)	0.74 (2.363)
Inflation	1.26** (0.582)	0.87*** (0.266)	1.43 (0.944)	1.20* (0.676)	1.00*** (0.320)	1.25 (1.112)
Interest rate	−1.42 (1.521)	−0.77 (0.695)	1.99 (2.485)	−0.21 (1.775)	−0.36 (0.840)	2.91 (2.957)
Constant	−27.67*** (6.277)	−25.43*** (2.869)	−189.68*** (10.363)	−20.30*** (7.286)	−23.58*** (3.449)	−175.50*** (12.252)
Observations	9,321	9,321	9,016	6,703	6,703	6,470
R-squared	0.07	0.09	0.08	0.06	0.09	0.07
Number of firms	872	872	872	621	621	621

Notes: Standard error is reported in parentheses. Significance codes: ***statistical significance at 1, **5 and *10%, respectively

(*continued*)

Table 3.

Variables	Non-shari'ah-complient firms		
	ROE	ROA	Growth
Size	3.72*** (0.864)	2.38*** (0.364)	15.37*** (2.220)
log_Capexp	0.92*** (0.274)	0.26** (0.116)	1.19** (0.515)
Leverage	−0.39*** (0.027)	−0.14*** (0.012)	−0.22*** (0.060)
TATA	3.69** (1.875)	1.00 (0.790)	0.66 (3.390)
MTBV	1.88*** (0.399)	1.26*** (0.168)	0.00 (0.812)
GDP	3.02 (2.369)	1.51 (0.998)	3.12 (3.394)
Inflation	1.24 (1.126)	0.48 (0.474)	1.75 (1.661)
Interest rate	−4.06 (2.911)	−1.65 (1.226)	−0.09 (4.426)
Constant	−46.52*** (12.221)	−29.98*** (5.150)	−223.50*** (30.404)
Observations	2,618	2,618	2,546
R-squared	0.12	0.12	0.09
Number of firms	251	251	251

why, as of 2014, more than 70% of the firms listed on Bursa Malaysia are Shari'ah compliant, an indication that these firms understand the positive impact of being Shari'ah compliant. The results are in line with earlier studies which show that Shari'ah compliance impacts the performance of firms positively, especially during the crisis time period (Sadeghi, 2008; Ho *et al.*, 2014; Kr and Fu, 2014).

Researchers do argue that, on the one hand, Shari'ah-compliant firms do have a lot of restrictions in terms of investment, business domain and leverage ratios; hence, it would be difficult for such firms to manage their profitability. However, on the other hand, the restrictions imposed by Shari'ah do help the firms to behave more prudently with greater transparency and business ethics, while avoiding excessive risk and leverage. The level of investors' trust in the case of Shari'ah-compliant firms is another factor that helps to increase the performance of the firms[6].

5.1 Robustness checks

We apply two types of robustness checks to assess the validity of our findings. Our results might be subject to endogeneity and might be affected by some unobservable factors which are not modelled in our analysis. Therefore, we introduce a two-step system generalized method of moments (GMM) model (Arellano and Bover, 1995; Blundell and Bond, 1998). This approach is particularly effective in dealing with endogeneity problems, which are typical drawbacks of the analyses in corporate finance literature.

More specifically, our estimations are based on the following equation:

$$Y_{it} = Y_{it-1} + +\beta_1 Size_{it} + \beta_2 Capexp_{it} + \beta_3 Leverage_{it} + \beta_4 TATA_{it} + \beta_5 MTBV_{it} + \beta_6 ME_{it} + \varepsilon_{it}$$

Second, we analyse how firms respond to changes in firm-specific and macroeconomic factors during global financial crises. Because aggregate spending reduces in the economy and liquidity was dried up from the market (Wagner, 2007), firms were prone to default during the turmoil period. To understand the affect crises, we create dummy variable of crisis which takes the value 1 if the year is 2008 and 2009, otherwise 0.

Overall, results in Tables 4 and 5 show a similar pattern as in the previous analysis. However, the size now has negative relationship with firm's profitability. Further, the results show that the global financial crises do not have any impact on Malaysian firms regardless of business model.

6. Conclusion

This study assesses the comparative performance of Shari'ah- and non-Shari'ah-compliant firms in Malaysia for the period 2000–2013. The results of this study show that Shari'ah compliance adds to firms' value as firms perform transactions according to Shari'ah and avoid non-permissible activities. Shari'ah compliance has positive impact on the profitability and growth of firms. This is the expected result, as theoretically Shari'ah compliance ought to bring betterment to the companies' operations as the firms operate within the ambit of Shari'ah rulings and regulations. All the signs are in line with previous studies and are justified.

This study also has policy implications. Because the study contributes to objectify the positive impact of Shari'ah compliance on firm's performance, it serves as a credible and factual proponent of the theoretical propositions of better firm performance through Shari'ah compliance. The study offers a non-biased and quantitative outlook, highlighting

Table 4.
Determinants of firm performance (GMM approach)

Variables	All firms			Shari'ah-compliant firms		
	ROE	ROA	Growth	ROE	ROA	Growth
ROE_{t-1}	0.38*** (0.029)			0.41*** (0.027)		
Size	−2.74*** (0.610)	−1.58*** (0.316)	−3.50*** (0.955)	−1.99*** (0.655)	−0.98*** (0.335)	−2.06* (1.160)
Capexp	2.91*** (0.410)	1.65*** (0.216)	3.07*** (0.714)	1.91*** (0.394)	1.13*** (0.210)	2.79*** (0.684)
Leverage	−0.10** (0.038)	−0.08*** (0.019)	−0.07 (0.052)	−0.14*** (0.029)	−0.08*** (0.015)	−0.04 (0.042)
TATA	2.19 (1.899)	−0.74 (0.976)	5.83* (3.257)	−1.15 (1.669)	−2.03** (0.886)	5.51* (3.009)
MTBV	1.42*** (0.541)	0.44* (0.246)	4.79*** (0.761)	1.28*** (0.458)	0.58*** (0.221)	5.68*** (0.705)
GDP	0.20*** (0.051)	0.12*** (0.026)	0.54*** (0.085)	0.16*** (0.047)	0.10*** (0.026)	0.55*** (0.092)
Inflation	−0.19** (0.092)	−0.06 (0.047)	−0.08 (0.161)	−0.16* (0.095)	−0.03 (0.050)	−0.25 (0.162)
Interest rate	0.27 (0.177)	0.13 (0.101)	0.52* (0.310)	0.40** (0.186)	0.24** (0.104)	0.16 (0.347)
ROA_{t-1}		0.36*** (0.029)			0.37*** (0.026)	
$Growth_{t-1}$			0.10*** (0.013)			0.07*** (0.013)
Constant	10.33* (6.057)	8.61*** (3.119)	12.80 (8.676)	10.73 (6.674)	5.31 (3.315)	−2.21 (11.221)
Observations	8,843	8,843	8,272	6,364	6,364	5,928
Number of firms	872	872	872	621	621	621
AR1	0.000	0.000	0.000	0.000	0.000	0.000
AR2	0.033	0.738	0.225	0.157	0.535	0.914
Hansen test	0	0	0.014	0	0	0.061
No. of instruments	133	133	133	133	133	133

Notes: Standard error is reported in parentheses. Significance codes: ***statistical significance at 1, **5 and *10%, respectively

(*continued*)

Variables	ROE	Non-Shari'ah-compliant firms ROA	Growth
ROE_{t-1}	0.39*** (0.018)		
Size	−0.98** (0.430)	−0.68*** (0.185)	−6.87*** (0.765)
Capexp	2.19*** (0.333)	0.77*** (0.149)	4.46*** (0.557)
Leverage	−0.01 (0.024)	−0.02** (0.011)	−0.07*** (0.028)
TATA	9.32*** (1.870)	1.19 (0.946)	8.15*** (3.029)
MTBV	2.53*** (0.441)	1.12*** (0.190)	−1.06* (0.621)
GDP	0.23*** (0.061)	0.15*** (0.030)	0.48*** (0.097)
Inflation	−0.39*** (0.095)	−0.21*** (0.049)	0.12 (0.185)
Interest rate	0.01 (0.228)	0.01 (0.090)	0.79** (0.372)
ROA_{t-1}		0.44*** (0.019)	
$Growth_{t-1}$			0.17*** (0.010)
Constant	−9.01** (4.431)	3.01* (1.785)	50.06*** (7.041)
Observations	2,479	2,479	2,344
Number of firms	251	251	251
AR1	0.000	0.000	0.000
AR2	0.026	0.793	0.088
Hansen test	0.08	0.056	0.46
No. of instruments	133	133	133

Table 4.

Table 5.
Effect of crisis

Variables	All firms			Shari'ah-compliant firms		
	ROE	ROA	Growth	ROE	ROA	Growth
ROE_{t-1}	0.37*** (0.030)			0.40*** (0.028)		
Size	−2.71*** (0.610)	−1.57*** (0.316)	−3.49*** (0.956)	−2.09*** (0.663)	−0.98*** (0.335)	−2.05* (1.161)
Capexp	3.07*** (0.420)	1.67*** (0.219)	3.05*** (0.716)	2.04*** (0.417)	1.14*** (0.215)	2.76*** (0.685)
Leverage	−0.10*** (0.039)	−0.08*** (0.019)	−0.07 (0.052)	−0.14*** (0.029)	−0.09*** (0.015)	−0.04 (0.042)
TATA	2.64 (1.914)	−0.65 (0.995)	5.74* (3.279)	−1.07 (1.671)	−1.97** (0.904)	5.24* (3.039)
MTBV	1.51*** (0.544)	0.44* (0.247)	4.79*** (0.762)	1.31*** (0.458)	0.58*** (0.222)	5.68*** (0.705)
Crisis	0.81* (0.433)	0.11 (0.221)	−0.08 (0.789)	0.42 (0.457)	0.07 (0.238)	−0.44 (0.789)
GDP	0.30*** (0.074)	0.13*** (0.035)	0.53*** (0.140)	0.22*** (0.077)	0.11*** (0.039)	0.49*** (0.141)
Inflation	−0.30*** (0.109)	−0.08 (0.053)	−0.07 (0.197)	−0.22* (0.118)	−0.04 (0.060)	−0.19 (0.193)
Interest rate	0.31* (0.179)	0.14 (0.103)	0.51* (0.310)	0.40** (0.186)	0.24** (0.106)	0.16 (0.347)
ROA_{t-1}		0.36*** (0.030)			0.37*** (0.027)	
$Growth_{t-1}$			0.11*** (0.013)			0.07*** (0.013)
Constant	7.90 (6.199)	8.28*** (3.182)	12.99 (8.813)	10.65 (6.674)	5.13 (3.401)	−1.65 (11.249)
Observations	8,843	8,843	8,272	6,364	6,364	5,928
Number of firms	872	872	872	621	621	621
AR1	0.000	0.000	0.000	0.000	0.000	0.000
AR2	0.042	0.758	0.224	0.169	0.541	0.918
Hansen test	0	0	0.012	0	0	0.056
No. of instruments	133	133	133	133	133	133

Notes: Standard error is reported in parentheses. Significance codes: ***statistical significance at 1, **5 and *10%, respectively

(*continued*)

Variables	Non-Shari'ah-compliant firms		
	ROE	ROA	Growth
ROE_{t-1}	0.39*** (0.019)		
Size	−0.75* (0.437)	−0.71*** (0.186)	−6.84*** (0.772)
Capexp	2.10*** (0.335)	0.77*** (0.149)	4.40*** (0.567)
Leverage	−0.02 (0.024)	−0.02** (0.011)	−0.07** (0.028)
TATA	10.82*** (1.916)	1.42 (0.968)	8.13** (3.136)
MTBV	2.77*** (0.447)	1.14*** (0.191)	−1.02 (0.656)
Crisis	1.99*** (0.442)	0.21 (0.207)	−0.39 (0.917)
GDP	0.42*** (0.074)	0.17*** (0.036)	0.43*** (0.146)
Inflation	−0.64*** (0.108)	−0.23*** (0.054)	0.17 (0.219)
Interest rate	0.26 (0.242)	0.03 (0.093)	0.79** (0.375)
ROA_{t-1}		0.44*** (0.019)	
$Growth_{t-1}$			0.17*** (0.010)
Constant	−13.74*** (4.600)	3.09* (1.783)	50.19*** (7.206)
Observations	2,479	2,479	2,344
Number of firms	251	251	251
AR1	0.000	0.000	0.000
AR2	0.024	0.783	0.088
Hansen test	0.122	0.059	0.432
No. of instruments	133	133	133

Table 5.

the pros of Shari'ah compliance beyond the constricted domain of religious beliefs. Hence, it contributes to positively influencing the public attitudes towards Shari'ah compliance by demonstrating the practical results of the theoretical claims.

As a favourable public attitude towards Shari'ah compliance burgeons, the demand for Shari'ah-compliant investments will increase. As more firms work under the umbrella of laws of Shari'ah to satisfy the increased demand, the firms' performance would increase, maximising the shareholder's return and increasing economic activity which in turn will strengthen the GDP.

This study is also subject to geographical limitation. Although Malaysia is one of the leading countries in Islamic finance, Islamic finance is also rapidly growing in countries such as UAE, Saudi Arabia and Pakistan, and macroeconomic factors in those countries might force the Shari'ah-compliant firms to behave differently. Therefore, further studies can be conducted based on sector-wise analysis of both Shari'ah-compliant and non-compliant listed firms with broader set of countries.

Notes

1. This study covers two important topics – *Shariah* compliance and firms' performances in Malaysia. As Malaysia is considered a top market player of Islamic finance industry, it is important to provide the background of Islamic finance in Malaysia. Data sourced from IFSB's Islamic Financial Services Industry Stability Report 2018.
2. www.bnm.gov.my/index.php?ch=57&pg=137&ac=612&bb=file
3. See https://us.spindices.com/documents/methodologies/methodology-dj-islamic-market-indices.pdf
4. Obiyathullah, "Growth and Development of the Islamic Capital Market". Islamic Finance in Malaysia: Growth & Development, Pearson.
5. It could be because of the restrictions imposed by Shari'ah to avoid excessive leverage and too much risk.
6. Some of the investors of *Shariah*-compliant firms invest in the firms solely because of the *Shariah* status of the firms. Thus, the firms try to abide by the laws of *Shariah* to satisfy their investors. Abiding by the laws of *Shariah* impacts the performance of the firms positively (Kr and Fu, 2014).

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Table A1.
Background of the Malaysian Islamic finance regulation

1983–1993	1994–2001	2002–2010	2011 and onward
Building foundation of legal, regulatory and Shari'ah framework	Increasing number of players, developing financial markets and harmonising Shari'ah interpretation	Market liberalisation, upgrading of infrastructures, strengthening of overall Islamic financial landscape	Increasing diversity of players and instruments, enhancing the dynamics of the financial markets, enhancing financial linkages with other jurisdictions
Phase 1 Instituting foundations of Islamic finance	Phase 2 Stimulating competition, activity generation and market vibrancy	Phase 3 Visioning, increasing international integration	Phase 4 Enhancing internationalisation of Islamic finance
• Islamic Banking Act 1983, Takaful Act 1984, Government Funding Act 1983, 1st Islamic Bank, 1st takaful operator	• Islamic windows, 2nd Islamic bank, 2nd takaful operator, Islamic money market, Shari'ah Advisory Council at BNM	Financial Sector Master plan (FSMP): 10-year roadmap, Foreign Islamic banks, Islamic subsidiaries, New takaful and retakaful licenses, Tax Neutrality Policy, IBFIM, SIDC, INCEIF and ISRA; Central Bank of Malaysia Act 2009; Malaysia International Islamic Financial Centre (MIFC)	• Financial sector blueprint – internationalisation of Islamic finance, Islamic Financial Services Act 2013

Source: SRIs & The Case for Islamic Investment Funds (2015) Report

Appendix 2

Table A2. Shari'ah-compliant securities on Bursa Malaysia

	June 2016	June 2015	June 2014	June 2013
Number of Shari'ah-compliant securities	671	677	666	800
Total listed securities	904	903	906	910
% to total listed securities	74.23%	73.86%	73.5%	87.9%
Market capitalisation (RM billions)				
Shari'ah-compliant securities	1,035.56	1,086.18	1,087.91	1,007.72
Total market capitalisation	1,667.37	1,694.78	1,770.42	1,598.81
% to total market capitalisation	61.81%	64.09%	61.4%	63.0%

Source: www.sc.com.my/data-statistics/islamic-capital-market-statistics/

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