

LIQUIDITY AND LEVERAGE: THE PERFORMANCE OF SHARIAH AND NON-SHARIAH COMPLIANT COMPANIES

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Abstract: Ratio analysis is the essential technique to learn about a company's financial health, strengths, and weaknesses. The Shariah Compliant Company (SCC) and Non-Shariah Compliant Company (NSCC) are developing very well in Malaysia. However, there have been several debates about the factors that contribute to the company's profitability that serve as a useful measure of its performance. This study aims to expand the knowledge regarding the performance of SCC and NSCC as determined by liquidity and leverage. Hence, 32 SCCs and 20 NSCCs in Bursa Malaysia were selected from the List of Shariah Compliant Securities by the Shariah Advisory Council of the Securities Commission Malaysia. The company's quick ratio (QR) and debt ratio (DR) represent liquidity and leverage respectively, while performance is represented by return on assets (ROA) and return on equity (ROE) covering the years 2017 to 2022. This research discovered that SCC recorded greater performance than NSCC. A varying relationship exists between both dependent variable and independent variable depending on whether the company is SC or NSC. Liquidity significantly influences the performance of SCC especially based on ROA, while NSCC's performance is significantly influenced by leverage. SCC in Malaysia needs to focus more on its liquidity. As for NSCC, it shall prioritize the leverage utilized by the company. The findings of this research can be the future guidance for researchers, developing companies, and investors who want to explore more about the competitive landscape in Malaysia, particularly in the SC and NSC markets.

Keywords: Shariah Compliant Company (SCC); Non-Shariah Compliant Company (NSCC); quick ratio (QR); debt ratio (DR); return on assets (ROA); return on equity (ROE)

1. Introduction

Ratio analysis is a fundamental tool used by stakeholders to gain insights into a company's financial health (Ravinder & Muskula, 2013). By scrutinizing key ratios like profitability, efficiency, and leverage, stakeholders can uncover valuable insights beyond numerical figures. The Shariah Compliant Company (SCC) and Non-Shariah Compliant Company (NSCC) are developing very well in Malaysia. SCC carefully adheres to Islamic law, avoiding activities such as interest and shunning certain sectors (Tarver, 2023), whereas NSCC enjoys more financial and industry freedom. SCC has gained popularity (Affandi, Zainuddin & Asari

(2021). Due to laws, the SCC is limited to specific commercial activities, therefore the NSCC may generate greater money. However, researchers observed that the SCC performed well and that the NSCC should strengthen its commercial operations. There have been several debates about the factors that contribute to the company's profitability that serve as a useful measure of its performance.

The theory of liquidity and profitability is pivotal in financial management, addressing the intricate balance between the companies' short-term solvency and long-term financial well-being. Panigrahi (2019), mentioned a trade-off theory, warning that excess liquidity can underutilize capital, affecting overall profitability. Ajanthan (2013), cited in Nishanthini and Meerajancy (2015), study on Sri Lanka trading companies supports a significant relationship between liquidity and profitability. According to the Pecking Order Theory, profitability, and financial leverage are inversely related (Ramnoher & Seetah, 2020). Pecking Order Theory considers a company's leverage ratio, which measures capital structure debt while evaluating performance. The companies' profitability and the specific factors that differentiate the SCC and NSCC performance were rarely found due to limited sources (Affandi et al., 2021). Therefore, it is imperative to do this research that complements and expands the existing literature regarding the performance of SCC and NSCC as determined by liquidity and leverage.

2. Literature Review

2.1 The Shariah Compliant Company

According to Hussain, Shahmoradi & Turk (2015), the SCC must adhere to Islamic values by refraining from taking an interest in corporate transactions as doing so is seen to be against them. It was also forbidden for the SCC to engage in illicit commercial dealings that would result in Syubhah, a situation in which there is uncertainty about what constitutes haram and halal (Ismail & Jalil, 2019). Aligning with the strict regulations, the Shariah Advisory Council (SAC) will play a pivotal role in verifying and monitoring the companies' daily business operations, are always comply with Islamic principles by performing regular inspections of the SAC's members (Hussain et al., 2015). Regulatory bodies like the Securities Commission Malaysia (SC) and Bursa Malaysia (BM) have their own special SAC department to monitor all the listed SCCs that comply with Islamic principles.

2.2 The Non-Shariah Compliant Company

NSCC conducts interest-based negotiations and business that violates Shariah law for Islamic finance. Salman & Nawaz (2018), suggest this category may include banking, insurance, and the entertainment business. The SC and BM use certain factors to identify and classify the NSCC from various sectors and industries. The NSCC commonly performs interest-based activities by offering loans with interest payments, which are against Islamic principles. Usually, the business entities that might cooperate with this deal structure are in the financial services sector that specifically aimed at the conventional banking and insurance industries (Song & Oosthuizen, 2014).

2.3 The Ratio Analysis

Financial ratio analysis refers to the systematic evaluation of a company's financial statements using ratios, to gain insights into the company's general health (Kumar Goyal, 2016). Alqam, Ali, & Hamshari (2021), stated that financial analysis using ratios has grown in significance as a crucial instrument for assessing the efficiency and efficacy of organizations. Ratio analysis is a valuable technique for enhancing decision-making processes by integrating numerical data derived from financial accounts into ratios (Kumar Goyal, 2016). Financial ratios can be categorized into several types, including liquidity ratio, leverage ratio, activity ratio, profitability ratio, growth ratio, and valuation ratio.

2.4 Performance of the Company

Previous research has examined the evaluation of company performance through the utilization of several financial metrics, including profitability and efficiency ratios such as return on assets (ROA), return on equity (ROE), return on investment (ROI), asset turnover, and operating expenses ratio (Patrick, Ogebe, Orinya & Alewi, 2013). This finding aligns with the study conducted by Huang & Chen (2015), wherein profitability was assessed using metrics such as ROA and ROE. Evaluation of company performance is an essential part of financial analysis as it provides insight into the firm's financial stability and operational efficacy. Key metrics like ROA and ROE have become significant indicators. ROA measures how much profit the company earns relative to its assets (Gitman & Joehnk, 2015). ROE measures the rate of return earned on the common shareholders' investment (Titman, Keown & Martin, 2018).

2.5 Liquidity and Performance of the Company

Liquidity is measured by the current asset (CA) and quick ratio (QR) demonstrates the capability of the company to pay its debt within one year and key indicator in measuring a company's performance from the short-term perspective (Ramanuj & Memon, 2023). QR excludes the calculation of inventory as it is the least liquid asset. (Ramanuj et al., 2023) stated that a QR is a useful measure to assess a company's ability to meet its short-term obligations promptly. Prior research has found a positive and significant correlation between profitability and the QR, highlighting the interplay between liquidity and profitability found by Affandi et al. (2021) and (Madushanka & Jathurika, 2018). However, Dioha, Mohammed & Okpanachi (2018) found an opposite finding where it shows the negative association between liquidity and profitability by using a QR.

2.6 Leverage and Performance of the Company

The solvency ratio, also known as leverage, relates to the utilization of assets to meet fixed expenses. It reflects the incorporation of debt to fund investments. The leverage ratio evaluates how much of a company's assets are funded by loans. This ratio evaluates a company's capacity to meet long-term obligations. Several ratios could be used to measure the leverage such as debt to asset ratio (DR) and debt to equity ratio. According to the Pecking Order Theory, profitability, and financial leverage are inversely related. The study conducted by Bhutta & Hasan (2013), on the relationship between the DR, ROA, and ROE revealed a negative correlation. Dogan (2013), Taslim (2017), and, Ahmad & Mohamad (2017) used DR to

examine the connection between leverage and company performance which shows a negative connection. The increasing leverage ratios of a company may harm profitability, subsequently affecting overall performance and growth. Companies, in response, tend to augment equity rather than debt in their business activities, as highlighted by Patrick et al., (2013). This observation aligns with findings from Taslim (2017), which investigated company performance in Malaysia and found a negative influence of leverage on the company's profitability. Shahar & Shahar (2015), examined the relationship between firm leverage and performance as measured by ROA and ROE and found that the performance of SCC is not influenced by the DR.

2.7 Conceptual Framework

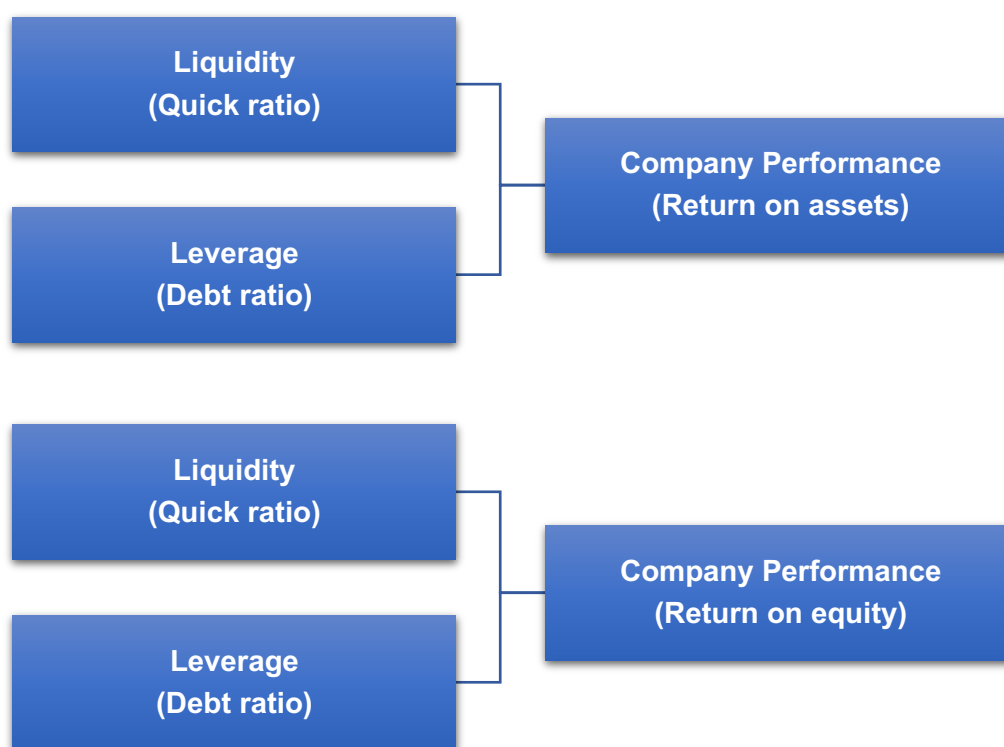


Figure 1. The Conceptual Framework

Figure 1 illustrates the conceptual framework used to analyze the influence of liquidity and leverage on the performance of SCC and NSCC. The independent variables QR and DR represent liquidity and leverage respectively. The dependent variables are the company's performance represented by ROA and ROE.

3. Methodology

This study aims to expand the knowledge regarding the performance of SCC and NSCC as determined by liquidity and leverage. 32 SCCs and 20 NSCCs in Bursa Malaysia were selected from the List of Shariah Compliant Securities by the Shariah Advisory Council of the Securities Commission Malaysia (SACSCM) available on the website of SC. Refinitiv Eikon data streams

from Universiti Kebangsaan Malaysia were used to collect QR, DR, ROA, and ROE covering the period of 2017 to 2022.

Statistical Package for Social Science (SPSS) is used to conduct descriptive analysis, correlation analysis, and regression analysis. The relationship between liquidity and leverage with the company's performance is examined by using a correlation analysis that measures the degree or the strength of association between two variables (Pallant, 2013). How much of the variance in the company's performance can be explained by liquidity and leverage is examined by using a regression analysis.

4. Results

4.1 Descriptive Analysis

Table 1. The Result of Descriptive Analysis

Variable	Minimum	Maximum	Mean	Standard Deviation
Shariah Compliant Company (SCC) n = 192				
ROA	-39.07	189.34	5.3251	16.60231
ROE	-51.04	420.96	12.0028	36.52866
QR	0.15	329.98	8.1208	34.27873
DR	0.01	90.30	15.4875	16.72877
Non-Shariah Compliant Company (NSCC) n = 120				
ROA	-45.01	76.18	1.8237	10.76436
ROE	-182.29	93.25	-0.0018	26.03155
QR	0.09	18.98	3.0104	3.66928
DR	0.23	221.82	25.1860	27.87987

Notes: (i) ROA refers to return on assets (ii) ROE refers to return on equity (iii) QR refers to quick ratio (iv) DR refers to debt ratio

4.2 Correlation Analysis

The interpretation of results for correlation analysis is referred to Cohen (1998, pp. 79-81) as cited in Pallant (2013).

Table 2. Result of the Correlation Analysis between QR and DR with ROA

	ROA		QR		DR	
	SCC	NSCC	SCC	NSCC	SCC	NSCC
ROA	1	1	0.477**	0.072	-0.170*	-0.174
QR			1	1	-0.183*	-0.419**
DR					1	1

** . Correlation is significant at the 0.01 level (2-tailed)

* . Correlation is significant at the 0.05 level (2-tailed)

Table 2 represents the correlation analysis between QR and DR with ROA. SCC shows a significant medium positive relationship between QR and ROA, $r = 0.477$, $n = 192$, $p < 0.01$.

A significant small negative relationship between DR and ROA, $r = -0.170$, $n = 192$, $p < 0.05$. For SCC, an increase in QR will increase the ROA, while an increase in DR will decrease the ROA. NSCC shows that no relationship between QR with ROA.

Table 3. Result of the Correlation Analysis between QR and DR with ROE

	ROE		QR		DR	
	SCC	NSCC	SCC	NSCC	SCC	NSCC
ROE	1	1	0.180*	0.094	0.238**	-0.271**
QR			1	1	-0.183*	-0.419**
DR					1	1

** . Correlation is significant at the 0.01 level (2-tailed)

* . Correlation is significant at the 0.05 level (2-tailed)

Table 3 shows the correlation analysis between QR and DR with ROE. For SCC, there is a significant small positive relationship between QR and ROE, $r = 0.180$, $n = 192$, $p < 0.05$ as well as DR with ROE, $r = 0.238$, $n = 192$, $p < 0.01$. An increase in QR and DR will increase the ROE. NSCC shows that there is no relationship between QR with ROE. However, DR and ROE have a significant small negative relationship, $r = -0.271$, $n = 120$, $p < 0.05$. For NSCC, an increase in DR will decrease the ROE.

4.3 Regression Analysis

Table 4. The Result of Regression Analysis for Shariah Compliant Companies (SCC)

	R	R ²	Sig. F	Coefficient		p-values Sig	
				QR	DR	QR	DR
ROA	0.485	0.235	0.001	0.462	-0.085	0.000	0.190
ROE	0.329	0.108	0.001	0.231	0.281	0.001	0.000

The regression analysis result for SCC is shown in Table 4. The correlation coefficient, $R = 0.485$ signifies a medium relationship between QR and DR with the ROA. The coefficient of determination, $R^2 = 0.235$, indicates that QR and DR account for 23.5% of the variance is insufficient to explain ROA because it is less than 60%. However, the total equation is significant, $p < 0.05$. For SCC, each unit increase in the QR significantly increases the ROA by 0.462, $p < 0.05$ and each unit increase in the DR reduces the ROA by 0.085 units.

$R = 0.329$ signifies a medium relationship between QR and DR with the ROE. $R^2 = 0.108$, indicating that the QR and DR account for 10.8% which is insufficient to explain the variance in the ROE. The total equation is significant, $p < 0.05$. For SCC, each unit increase in the QR and DR increases the ROE by 0.231 units and 0.281 units respectively. The QR and DR, significantly contribute to the ROE as $p < 0.05$.

Table 5. The Result of Regression Analysis for Non-Shariah Compliant Companies (NSCC)

	R	R ²	Sig. F	Coefficient		p-values Sig	
				QR	DR	QR	DR
ROA	0.174	0.030	0.165	-0.001	-0.175	0.992	0.084
ROE	0.272	0.074	0.011	-0.024	-0.281	0.810	0.005

Table 5 shows the NSCC regression analysis result. $R = 0.174$ implies a small relationship between the QR and DR with the ROA. $R^2 = 0.030$, indicates that the QR and DR account for 3.0% which is insufficient to explain the variance in the ROA. Each unit increment in the QR and DR reduces the ROA by 0.001 units and 0.175 units respectively. $R = 0.272$ implies a small relationship between the QR and DR with the ROE. $R^2 = 0.074$, indicates that the QR and DR account for 7.4% which is insufficient to explain the variance in the ROE. The total equation is significant, $p < 0.05$. Each unit increment in the QR and DR reduces the ROE by 0.024 units and 0.281 units respectively. The results show that DR significantly contributes to the ROE, $p < 0.05$.

5. Discussion and Conclusion

Descriptive analysis reveals that SCC recorded greater profitability as concurred with Affandi et al. (2021). This implies that SCC has better operational efficiency and financial stability than NSCC. As a result, the standard deviation of SCC is equally higher, indicating that the company is exposed to greater risk. SCC's capacity to fulfill current commitments is better than NSCC's, however, each company has sufficient liquid assets as shown by QR. NSCC is relying more on debt financing as indicated by DR. This finding supported the Pecking Order Theory where financial leverage and profitability have an inverse relationship (Ahmad et al., 2017).

The correlation analysis for SCC concurs with the findings by Affandi et al. (2021) and Madushanka et al., (2018), which found a positive relationship between a company's performance and liquidity. It also indicates that a rise in liquidity will increase the company's performance. This result contradicts the discoveries of Dioha et al., (2018) who identified a negative correlation between liquidity and profitability via the use of a QR. However, NSCC demonstrates that liquidity does not affect profitability. Leverage affects the ROA of SCC and NSCC in contrast with Shahar et al., (2015). Focusing on ROE, for SCC, the increase in leverage the ROE will increase as well, while for NSCC, the increase in leverage will decrease the ROE. The negative correlation between leverage and profitability is concurred by Ahmad et al., (2017) and Bhutta et al., (2013).

Regression analysis shows that for SCC and NSCC, liquidity and leverage alone are insufficient to explicate the company's performance. There is another variable that shall be considered by the company and investor including the efficiency ratio and stock market ratio that may also influence a company's performance regardless of whether they are SCC or NSCC. Nonetheless, analysis proved that as compared to leverage, liquidity significantly impacts ROA for SCC. Maintaining liquidity provides financial stability and helps prevent higher defaults on debt to boost investor confidence, attracting more investments and creating new company prospects, eventually leading to greater company performance. Liquidity indicates healthier working capital management, which can lower inventory holding costs, convert receivables to cash faster, and manage payables more efficiently, improving operational efficiency and potentially raising profit margins, which can indirectly raise ROA. While for the ROE, leverage, and liquidity significantly contribute, especially leverage contrary to Shahar et al., (2015). Strategic utilization of debt finance by a company may enhance profits for shareholders. The company may boost its ROE by using borrowed cash to produce profits, beyond what it might accomplish with capital only.

When it comes to the performance of NSCC, leverage has a greater impact than liquidity. Debt financing may enhance profitability by providing extra resources for initiatives that provide returns. When considering debt financing, NSCC must carefully evaluate the ideal debt ratio to maximize profitability. Too much debt can increase financial risk and lower long-

term profitability. Regardless of whether SCC or NSCC, ROA is important for all stakeholders, including lenders, as it monitors the company's efficiency, whereas ROE is deemed important to shareholders as it represents their return on investment.

SCC in Malaysia needs to focus more on its liquidity while NSCC shall prioritize the leverage utilized by the company. In terms of investors who are seeking stability, reduced risk, and morally oriented investments may find the SCC to be a major benefit. If the investor prioritizes larger potential returns and high risk, it is recommended to develop an investing plan focused on NSCC. The findings of this research can be the future guidance for researchers, developing companies, and investors who want to explore more about the competitive landscape in Malaysia, particularly in the SC and NSC markets.

This research is highly recommended for stakeholders to add value in decision-making as it provides an analysis of the influence of liquidity and leverage on the performance of SCC and NSCC. There are other variables to examine the factors that influence the profitability of the company such as efficiency ratio and stock market ratio. It is advised for future researchers to include those variables as it may result in a strong finding and enhance the knowledge of ratio analysis.

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