



UNIVERSITI PUTRA MALAYSIA

***SHARIAH DISCLOSURE AND ITS EFFECT ON FINANCIAL
PERFORMANCE OF MALAYSIAN SMEs***

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PERFORMANCE OF MALAYSIAN SMEs**

By

AIN FARAHIN BINTI NOOR AZMAN

**Thesis Submitted to the School of Graduate Studies, Universiti Putra
Malaysia, in Fulfilment of the Requirements for the Degree of Master of
Science**

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Abstract of thesis presented to the Senate of Universiti Putra Malaysia in
fulfilment of the requirement for the Degree of Master of Science

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January 2020

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Shariah disclosure has become an important aspect in a Small-Medium Enterprises (SMEs). The disclosure of shariah information would enhance the transparency and accountability of SMEs towards its stakeholders which in return helps promote the long term profitability and sustainability. Thus, the objectives of this study are to: (1) examine the extensiveness of Shariah disclosure and (2) investigate the relationship between Shariah disclosure on product and services, financing, earnings and expenditure, social functions and environment and its effect on financial performance of SMEs in Malaysia. In total, 131 respondents comprised of owners and top management of SMEs in the state of Selangor, Kedah, Pahang, and Johor. The questionnaire was developed based on Shariah Index for Islamic Social Reporting and the data was analysed using multiple regression.

The findings indicated that Shariah disclosure on financing found to have significant relationship on the financial performance of SMEs. In contrast, products and services, earning and expenditure, social functions and environment were found to have no significant relationship on the financial performance of SMEs. The results also show that working environment for workers was disclosed extensively by SMEs while, earning expenditure on non-Shariah compliant the disclosure was less extensive.

The results of the study would be useful to SMEs and policy-makers in Malaysia for example, the SME Corp. The relevant agencies or government should come out with new guidelines with regard to Shariah disclosure for safeguarding stakeholders' interest.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk Ijazah Sarjana Sains.

**PENDEDAHAN SYARIAH DAN KESAN KEPADA PRESTASI KEWANGAN
IKS DI MALAYSIA**

Oleh

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Pendedahan Syariah telah menjadi satu aspek penting dalam Industri Kecil Sederhana (IKS). IKS yang komited terhadap ketelusan dan akauntabiliti menunjukkan bahawa pendedahan Syariah membantu mempromosikan keuntungan jangka panjang pelaburan mereka. Walau bagaimanapun, tidak semua IKS di Malaysia mengamalkan pendedahan Syariah dalam laporan tahunan mereka. Oleh itu, objektif kajian ini adalah untuk: (1) memeriksa keberkesanan pendedahan Syariah dan (2) menyelidiki hubungan antara pendedahan Syariah ke atas produk dan perkhidmatan, pembiayaan, pendapatan dan perbelanjaan, fungsi sosial dan persekitaran dan kesannya terhadap prestasi kewangan IKS di Malaysia. Secara keseluruhan, 131 responden terdiri daripada pemilik dan pengurusan atasan IKS di negeri Selangor, Kedah, Pahang, dan Johor.. Soal selidik itu dibangunkan berdasarkan Indeks Syariah untuk Pelaporan Sosial Islam dan data dianalisis dengan menggunakan analisis regresi berganda.

Penemuan menunjukkan bahawa pendedahan Syariah mengenai pembiayaan didapati mempunyai hubungan yang signifikan ke atas prestasi kewangan IKS. Sebaliknya, produk dan perkhidmatan, pendapatan dan perbelanjaan, fungsi dan persekitaran sosial didapati tidak mempunyai hubungan yang signifikan ke atas prestasi kewangan IKS. Keputusan juga menunjukkan bahawa persekitaran kerja untuk pekerja didedahkan secara besar-besaran oleh IKS sementara, perbelanjaan yang diperolehi daripada ketidakpatuhan terhadap Syariah yang mematuhi pendedahan itu kurang luas.

Keputusan kajian ini berguna kepada IKS dan pembuat dasar di Malaysia, contoh seperti, SME Corp. Agensi berkaitan atau kerajaan harus mengeluarkan garis panduan baru berkenaan dengan pendedahan syariah untuk menjaga kepentingan pihak berkepentingan.

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This thesis was submitted to the Senate of the Universiti Putra Malaysia and has been accepted as fulfilment of the requirement for the degree of Master of Science. The members of the Supervisory Committee were as follows:

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institution
ACCA	Association of Chartered Certified Accountants
CEO	Chief Executive Officer
CIF	Commercialization Innovation Fund
CSR	Corporate Social Responsibilities
DV	Dependent Variable
EE	Earning and Expenditure
EN	Environment
F	Financing
GDP	Gross Domestic Products
INCEIF	International Centre for Education in Islamic Finance
IRB	Islamic Retail Banking
IV	Independent Variable
MAHA	Malaysia Agriculture, Horticulture and Agrotourism
MITI	Ministry of International Trade and Industry
NSDC	National Skill Development Corporation
PS	Product and Services
SF	Social Function
SME	Small-Medium Enterprise
SMIDEC	Small Medium Industries Development Corporation
SPSS	Statistical Package for Social Science
SSFS	Shariah-compliant SMEs Financing Scheme

CHAPTER 1

INTRODUCTION

1.1 Introduction

This chapter introduces the thesis: Shariah disclosure and its effect on financial performance of SMEs. In specific, section 1.1 highlights the background of the study. Section 1.2 focuses on the problem statement. The research questions are in section 1.3, whereas the research objectives are in section 1.4. The operational definitions are explained in section 1.5. Section 1.6 and 1.7 highlights the contribution of the study and scope of the study, and lastly, section 1.8 is the organization of the thesis.

1.2 Background of the study

Small and Medium Enterprises (SMEs) are essential components of the economy in developing countries including Malaysia. According to Hashim (2000), SMEs in Malaysia are expected to contribute 50 percent of the gross domestic product (GDP) in 2020. The exporters of SMEs are mainly in manufacturing sector (57.6%), services (40.6%) and agriculture (1.8%). Based on the statements made by various organizations and ministries over the past decades, the total of SMEs could be in the range of 10,000 to 30,000. Recognising the SMEs potential and future growth to the Malaysian economy, the government of Malaysia has initiated greater efforts in encouraging SMEs to involve in international business (Chelliah, Sulaiman, and Yusoff, 2010). Various efforts are including but not limited to increase allocation of development funds, facilitate financing application, easy market access to small business, capacity building and talent development. Thus, performance of SMEs is vital as it has direct effect on national economic growth.

One aspect that is important in performance of SMEs is Shariah information disclosure in annual reports. According to Abdullah and Hoetoro (2011), it is important to adopt Islamic or Shariah principles as one way to empower SMEs. Usually, adhering to Shariah principles or staying "Shariah compliant" means observing strictly to the permissible (halal) and abstaining from the prohibited (haram) as commanded by God (Azri, Rahman, Mohd, Hafiz, Yaakub, and Long, 2018). When an organization disclose their information to customers such as in

the category of products and services, financing, takaful, stocks, and hotel business they have the trust to involve in it.

Information disclosed must be based on mandatory disclosure and voluntary disclosure. According to Ousama & Fatima (2010), mandatory disclosures are items that companies must disclose because of statutory regulations. Therefore, it is the minimum level of information to be disclosed in the annual reports. Meanwhile, voluntary disclosure is defined as that which is not mandated; thus, it constitutes information additional to statutory requirements (Ousama & Fatima, 2010). Disclosure of information on the Shariah compliant to stakeholders is considered necessary as it can attract and increase confidence among Muslim customers. As such, an organization voluntarily disclosed information to guarantee stakeholders that it is a decent organization, transparent and accountable to its stakeholders.

In the context of public listed companies, the responsibility to monitor the disclosure of Shariah principles in annual reports falls under the Shariah Supervisory Board (SSB). However, for Small Medium Enterprises (SMEs) industries, the disclosure practices are monitored by the Board of Director of the enterprise. Knowing whether the information disclosed is implemented according to the Shariah principles, stakeholders and the manager of SMEs should act according to recommendation by Board of Directors. The Qur'an suggests mankind to involve in activities that are lawful and good and also prevent those that can dispute in the society and harm people and the environment (Mohd-Sanusi, Ismail, Hudayati, and Harjito, 2015).

Those companies whose activities are compliant with the principles of Shariah are classified as the Shariah approved companies. The non-Shariah approved companies usually those companies that involved in activities that contradict to the principles of Shariah, such as debt interest (riba), gambling (maysir), and producing or selling prohibited products or services (Mohd-Sanusi et al., 2015). Therefore, the aim of this research is to look at the importance of information disclosure based on Shariah compliance and its effect on SMEs's financial performance in Malaysia.

1.3 The Motivation of the study

The general motivation of this study is that Shariah information disclosure is one of the aspects that can be used as communication through SME industries of their financial performance. Shariah information disclosure is an important aspect of the screening process of the SME reports. Disclosing all information is also important from the Islamic perspective for people in the societies where they operate. In this regard, products and services, financing, earnings and

expenditure, social functions and environment Shariah information disclosure of SMEs financial statement that this research sought to explore.

In pursuit of this aim, this study primarily examines the extensiveness of Shariah information disclosure and the effect of the financial performance of SMEs in Malaysia. This is to create awareness on the importance of Shariah aspects among SMEs. It is to ensure that the responsibility of every organization towards the Muslim society and stakeholders as Malaysia is known to be one of the Muslim countries in the world.

Another motivation of this study is to alert Muslims on the importance of Shariah aspects in a company. As all Muslims are responsible for living in the world by obeying the rules of God. Industries based on Shariah aspects have the responsibility towards God and society in making sure the guidelines of Shariah aspects are following Islamic law. Therefore, delivering products and information on Shariah aspects is a must. This research motivates the SME owners on the importance of Shariah information disclosure.

Therefore, this study aims to examine the extensiveness of Shariah information disclosure and the effect on the financial performance of SMEs.

1.4 Problem Statement

One dimension that is important in corporate reporting is disclosure of Shariah information to stakeholders especially Muslim decision makers. Haniffa (2002) noted that Shariah information disclosure can be regarded as demonstration of accountability of companies towards stakeholders. In Shariah disclosure, the stress on social justice goes beyond reporting on the environment, minorities interest and employees (Othman et al, 2009). It can include issues related to well being of society such as interest and unfair trading (Sulaiman, 2005), zakat distribution (Othman et al, 2009) and donations (Abu Kassim, 2012). Muslims stakeholders aware of the social responsibility of the company in terms of its halal and haram status, therefore demands more information (Othman et al., 2009).

Prior studies in conventional setting suggest that there is a link between information disclosure practice and company's profitability (Janggu, 2004). Also, in the context of Shariah disclosure of public listed companies, studies suggest that there is a relationship between Shariah disclosure and financial performance (Yusoff, 2018). These studies suggested that profitable companies disclosed more information than the less profitable companies. This implies that the management has acted in the best interest of stakeholders. Similarly, SMEs that run the business according to Shariah are expected to disclose information based on Shariah principles as a means to show accountability towards society.

Being accountable to society means voluntarily disclosing the information that is material to them in decision making. Although there are a number of studies on information disclosure among SMEs in general (Russell, 2015; Srairi, 2015), study that examines the extensiveness of Shariah information disclosure of SMEs in Malaysia and its effect on the financial performance of SMEs in emerging economies is sparse. It is reasonable to argue that examining this Shariah information disclosure by SMEs is also important as it centers on stakeholder's belief especially Muslim's stakeholders in fulfilling their spiritual needs. Indeed, such disclosure may enhance the SMEs' financial performance as evident in past studies within the context of public listed companies.

Moreover, in practice, it seems that SMEs are lacking in the disclosure of Shariah information. Compared to public listed companies in the country, there is a clear reporting standard on how to disclose Shariah information. At present, there is no guideline for SMEs to follow in reporting Shariah information. Thus, SMEs may be unclear on the knowledge of disclosing information on Shariah Compliance. This could be the contributing factor to why it is yet a practice among SMEs. This gap needs to be explored and filled. Therefore, this paper aims to determine the extent of Shariah information disclosure among SMEs in Malaysia. This research is also to see its effect on Shariah information disclosure and the financial performance of SMEs.

1.5 Research Questions

The research questions brought up here are questioning:

- i. What is the extensiveness of Shariah information disclosure by SMEs?
- ii. What is the relationship between Shariah information disclosure and the financial performance of SMEs?

1.6 Research Objectives

The objectives of the present study are as follows:

- i. To examine the extensiveness of Shariah information disclosure among SMEs in Malaysia.
- ii. To examine the relationship between Shariah information disclosure and financial performance of SMEs.

1.7 Operational Definitions

The topic for this research is Shariah information disclosure and its effect on performance among SMEs in Malaysia. Based on the topic that has been stated, it means that the information being disclosed among the SMEs in Malaysia is Shariah aspects as it is in line with the Shariah principles. However, each word can be defined in various kinds of ways and different perceptions of other people. The following subsections define the meaning of each word used in this study.

1.7.1 Information Disclosure

Disclosure term, in the widest sense, is meant to provide information. In accounting, the term is used in a more limited way and is meant just presentation of financial information of the company in financial or annual reports. In some cases, the disclosure will be even more limited, and it means the presentation of financial information which is not provided in the financial statements (Hejazi, Rahmani, and Mozafari, 2010). So, disclosure in the most limited definition includes management analysis and discussion, descriptive notes coupled with financial statements, and complementary financial statements. Information disclosure is the center resource efficiency in capital market, and any information would affect investors' decisions should be revealed by companies.

According to Abadi and Janani (2013), definitions of disclosure, discussed mandatory and voluntary disclosure, disclosure levels, and disclosure audience, and at the end, reviewed and determined the relationship between the quality of disclosure and characteristics such as information asymmetry, profit management, capital expenditure, and corporate size.

1.7.2 Shariah compliance

According to Kettel (2011), Shariah is an Arabic word meaning the path to be followed. It is the oath not only leading to Allah but the path believed by all Muslims to be the path shown by Allah, the Creator Himself through His Messenger, the Prophet Muhammad PBUH. It is the way that Muslims are obliged to strive for the implementation of that path, and no other path. Hence Shariah covers not only religious rituals, but also many aspects of everyday life, politics, economics, banking, business or contract law, and social issues.

For Grais and Pellegrini (2006), Shariah compliance practically means four things: (1) not to engage in interest-based transactions; (2) not to conduct a purely financial transaction disconnected from real economic activity; (3) not to participate in a transaction where there is exploitation of any party; and (4) not to participate in activities regarded as harmful to society.

1.7.3 Small Medium Enterprises (SMEs)

According to SME Corp Malaysia (2018), SMEs are independent, non-subsiary firms that employ less than a given number of employees. There are different given numbers across countries. The most constant upper limit designating an SME is 250 employees, as in the European Union. However, the United States considers SMEs to include firms with fewer than 500 employees and while some other countries set the limit at 200 employees. The definition covers all sectors, namely services, manufacturing, agriculture, construction and mining, and quarrying.

Several full-time employees and sales turnover are the two criteria used in determining the definition with the "or" basis as follows:

1. For the manufacturing sector, SMEs are defined as firms with several full-time employees not exceeding 200 or sales turnover not exceeding RM50 million.
2. For the services and other sectors, SMEs are defined as firms with several full-time employees not exceeding 75 or sales turnover not exceeding RM20 million.

1.7.4 Financial performance

Eshna (2017), stated that financial performance in broader sense refers to the degree to which financial objectives being or has been accomplished and is an important aspect of finance risk management. It is the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation.

There are five financial performance measures stated by Pearce, Freeman, and Robinson, (1987), which is the sales, stock prices, earnings per share (EPS), return on equity (ROE), and return on investment (ROI) were adopted as measures for determining the value of formal planning for organization performance. Return on equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity. Because shareholders' equity is equal to a company's assets minus its debt, ROE could be thought of as the return on net assets. Moreover, Return on Investment (ROI) is a performance measure used to evaluate the efficiency of an investment or compare the efficiency of a number of different investments. ROI tries to directly measure the amount of return on a particular investment, relative to the investment's cost. To calculate ROI, the benefit (or return) of an investment is divided by the cost of the investment. The result is expressed as a percentage or a ratio.

1.8 Significance of the Study

This study is significant considering the inconclusiveness of the relationship between Shariah information disclosure and the financial performance of SMEs, as it is a complex issue that various variables have been used to interact with their relationship.

The findings for this study contributes to the extent of knowledge on the Shariah information disclosures among SMEs. This is to see the usefulness of the information that has been disclosed voluntarily according to Shariah aspects. Voluntary disclosure may include information from an Islamic perspective because a reappearance of Islam-led Muslim decision makers expects enterprises to disclose more information that helps them fulfill their spiritual needs and not only limited to conventional disclosure (social or environment).

This study also contributes to the SME industries by highlighting the information that needed to be disclosed by the industries related to Shariah. It provides awareness to the SMEs on the importance of disclosing financing information in their annual report. It gives benefits to the industries on the significance of having an information disclosure within the SMEs according to the Shariah principles because they are sure of the product they are involving in. Therefore, disclosing information on Shariah aspects can affect the financial performance of SMEs.

Moreover, this research helps the regulator or the policymakers in making policies on improving the financial performance of SMEs. This information will lead the regulators and assistance to provide funds and incentives to do training related to Shariah information disclosure. It is hoped that at the end, it will help SMEs in increase the GDP by increasing total production, and regulators to provide more awareness training, campaign to make SMEs known on the production of product produce from their enterprise. There are other factors so that it can give further understanding of whether the level of conventional disclosure is the same as to Islamic disclosure from Shariah-compliant companies. It is useful to prepare financial statements and increase the financial performance of the SMEs.

1.9 Scope of the study

This study is based on its basic area to investigate the extensiveness of the Shariah information disclosure to the financial performance of SMEs and the Shariah information disclosure as the independent variables. Shariah information disclosure is important in enhancing and protecting the Islamic identity of SMEs in Malaysia. Disclosing the information related to Shariah shows

the transparency and accountability of SMEs towards their financial performance. Therefore, this study drew a sample from SMEs through a program set for SMEs according to different regions.

The scope of this study covers certain regions in Malaysia such as the Southern Region (Johor), Eastern Region (Pahang) and Northern Region (Kedah). It is not possible to cover all regions of the entire Malaysia because of the time frame and financial constraints. Data for the studies have been collected from the employees of SMEs in the Northern Eastern Southern region of Malaysia

Furthermore, the studies cover five elements of Shariah information disclosure variables that are products and services, financing, earning and expenditure, social funds, and environment.

1.10 Organizations of Thesis

This section explains the organization of chapters for this study. Chapter One is an introduction to the studies which includes the background of the study focusing on Shariah Information Disclosure, the background of SMEs in Malaysia, the statement of the research problem, the research questions and objectives and the importance of the research are highlighted.

Chapter Two begins with the background of SMEs in Malaysia and followed by the information disclosure that is explained through conventional and Islamic perspectives. The relevant empirical studies are also stated on the independent variables: Shariah information disclosure that is products and services, financing, earning and expenditure, social funds, and environment. The dependent variable: Financial Performance of SMEs; the annual sales and the annual net profit.

Chapter Three discusses the research design, and the study using the quantitative method, research paradigm, research methods, questionnaire design and measurement of data analysis. The data collection method is surveyed by using questionnaires and analyzed using descriptive analysis and regression using SPSS to answer the objective and hypothesis of the research.

Chapter Four presents and discusses the findings of the objectives proposed and the hypothesis, detail of the respondent's profile. Regression result discussion to evaluate the significant impact between the independent and dependent variables, and finally, conclude the overall hypothesis.

Chapter Five discusses the summary of the research findings, conclusions, recommendations of the next research and limitations of the study. It overviews the Shariah information disclosure and the financial performance of SMEs.



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