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OWNERSHIP STRUCTURE OF FAMILY-OWNED
FIRMS AND DEBT FINANCING.
EVIDENCE ON *SHARI'AH*-COMPLIANT FIRMS
IN MALAYSIA

Razali Haron

Abstract

This study examines the impact of ownership structure on the debt financing of 556 Shari'ah compliant firms in Malaysia from 2000-2015. This study reveals that the nature of family-owned firms does have great influence in the debt financing decisions and being closely guided by the Shari'ah principles with the restriction imposed on the debt consumption level allowed seem to have significant effect on the debt financing of Shari'ah-compliant firms understudy as well. Fear of the dilution of controlling power over the firms for these family owned and the characteristics of Shari'ah-compliant being governed by certain Shari'ah regulation have significant influence on debt consumption in the capital structure. Certain significant determinants seem to enhance the unique nature of these firms regarding the debt financing decision. This study contributes to the literature by providing insights of the factors affecting the debt financing of family owned, Shari'ah-compliant firms in Malaysia.

Keywords: Islamic Finance, Governance, Ownership, Ownership Identity, *Shari'ah*-compliant, Malaysia

1.0 Introduction

Literature has been witnessing conflicts within a firm involving the shareholders and the management of the firm. This so called agency conflict is a headache to all players in the business world particularly within the firm as it has bad impact on the performance of the firm thus gives negative impact on firm value. This conflict summons for good and effective corporate governance. One element in corporate governance that is believed to have the capability to ease agency conflict within a firm is the ownership structure of the firm, may it be concentrated or diverse ownership. However, studies on how ownership structure influences firm performance in the manner that the firm decides on their financing choices in the account of the agency conflict are still very limited, particularly with regards to *Shari'ah*-compliant firms. *Shari'ah*-compliant firms are very different in nature as compared to the conventional ones. This is due to certain *Shari'ah* regulations that the firms need to comply to. Certain standard criteria have been set by the *Shari'ah* Advisory Council (SAC) set up by the Securities Commission in the case of Malaysia in determining *Shari'ah*-compliant activities, making them *Shari'ah*-compliant firms. Being guided by *Shari'ah* rules and regulations, the capital structure of these firms may not be similar to that of the conventional and the determining factors may also be different. Likewise, the impact of ownership structure may also be different following the two distinctive natures of both *Shari'ah*-compliant and conventional firms, thus requires further investigations.

Malaysia has been widely recognised as the world leader in Islamic capital market (ICM) with a market size of RM1.7 trillion, which has more than doubled over the last decade. As the only country in the world with a framework for Islamic fund management companies, it now houses 20 full-fledged Islamic fund managers including large international firms. Combined with other fund management companies operating Islamic windows, Malaysia has RM149.6 billion worth of Islamic assets under management (AUM), which is among the largest in the world. Securities Commission Malaysia (SC) released an updated list of *Shari'ah*-compliant securities approved by its *Shari'ah* Advisory Council (SAC) which

took effect on 26 May 2017. The list featured a total of 676 *Shari'ah*-compliant securities which constitute 75% of the total 904 listed securities on Bursa Malaysia (as at 22 May 2017). It included 23 newly classified *Shari'ah*-compliant securities and excluded 13 from the previous list issued in November 2016. The Islamic capital market accounted for 59.56% of Malaysia's capital market. The market size stood at RM1,691.64 billion in 2016 comparable to RM1,694.11 billion in 2015 (ICM Bulletin 2016).⁵²

2.0 Literature Review

Ownership Structure and Agency Conflict

When talking about agency conflict, the conflict arises between manager and owner when managers manipulate the capital structure decision to serve their own interest at the expense of value maximization activities of the firm and neglecting the interest of owners or shareholders.⁵³ When this happens, debt is usually employed as disciplining mechanism to restrict managers' self-interest investment decisions.⁵⁴ When it comes to concentrated ownership especially family-owned, entrenched manager is a common problem facing family-owned firms. It is evidenced that entrenchment has negative effect of the performance of the firm as entrenched managers are more inclined to engage with investments that are not serving the interest of the shareholders.⁵⁵ These entrenched managers may opt to lower debt consumption as to avoid the disciplinary mechanism that comes with debt engagement.

Highly concentrated ownership normally has different aims

⁵² ICM Bulletin (July 2016 – 15 January 2017), Vol. 11 No. 2, accessed June 18, 2017, https://www.sc.com.my/wp-content/uploads/eng/html/icm/17_11_05_msianicm.pdf

⁵³ M.C. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics*, 3(4), (1976), 308.

⁵⁴ S. Grossman and O. Hart, "Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation." *Bell Journal of Economics*, 11, (1980), 44.

⁵⁵ P. Kumar and R. Rabinovitch, "CEO Entrenchment and Corporate Hedging: Evidence from the Oil and Gas Industry." *Journal of Financial and Quantitative Analysis*, 48(3), (2013), 890.

and visions as compared to diverse ownership firms. These firms are more particular about the longevity and the succession of the firms to the next generation and the next for as long as it takes without any intrusions from outside, not merely economic goals thus they will not opt to debt financing as to avoid bankruptcy risk and the risk of losing the firm.⁵⁶ Looking at the characteristic of *Shari'ah*-compliant firms for this matter, these firms are obliged not to consider only economic profits, longevity and succession but also the spiritual obligation and the welfare of the *ummah*.⁵⁷ Being *Shari'ah* compliance, they must adhere to the debt ratio restriction set by the *Shari'ah* Advisory Council (SAC) of Securities Commissions where they must maintain less than 33% of debt ratio in their financing decision, thus limits the consumption of debt as well.

Normally concentrated ownership and family-owned are known to be risk averse thus will avoid unnecessary risks that may come with debt financing.⁵⁸ Nevertheless, the fear of losing control or dilution of control over the firm, family firms would prefer debt over equity to curb the coming in of the outsiders to the firm.⁵⁹ Thus, the characteristics of being risk averse and the fear over dilution of control must inevitably affect the financing decisions of family-owned firms. Looking at *Shari'ah*-compliant firms, the distinctive characteristic of these firms as compared to the conventional ones may also have significant influence on their financing decision. Firms will be classified as *Shari'ah*-compliant when they have satisfied several *Shari'ah* principles and regulations in their daily operation and activities. For example, the Accounting

⁵⁶ G. Corbetta and C. Sarvat 2004, "Self-Serving or Self-Actualizing? Models of Man and Agency Costs in Different Types of Family Firms: A Commentary on "Comparing the Agency Costs of Family and Non-Family Firms: Conceptual Issues and Exploratory Evidence." *Entrepreneurship Theory and Practice*, 28, (2004) 360.

⁵⁷ J.A. Ramli and M.I. Ramli, "Corporate Governance and Corporate Performance of Malaysian Companies: Examining from an Islamic Perspective." *Procedia Economics and Finance*, 35, (2016), 149.

⁵⁸ A. Shleifer and R.W. Vishny, "A Survey of Corporate Governance." *The Journal of Finance*, 52(2), (1997), 745.

⁵⁹ R. Anderson and D. Reeb, "Founding-Family Ownership, Corporate Diversification, and Firm Leverage." *Journal of Law and Economics*, 46 (2), (2003), 662.

and Audit Organization for Islamic Financial Institutions (AAOIFI) *Shari'ah* standard No. 21 states that debt financing for *Shari'ah*-compliant firms must not exceed 30% of their total capital. Similarly, the Dow Jones Islamic market and Financial Times Stock Exchange determine 33% or less for debt and equity ratio and less than 9% of the firm's total income for interest-related income. Likewise, on 18 June 2012, the SAC has made a notable revision on the screening methodology as to ascertain the continuous compliance of the *Shari'ah* firms. The revised screening procedure adopts a so called two tier quantitative screening while keeping the existing qualitative screening. The first tier screening requires the *Shari'ah* compliant firms to adhere to the 5% and 20% benchmarks on the contribution of non-permissible activities and the level of contributions of mixed rentals from *Shari'ah* non-compliant activities respectively. The second tier is that the Cash/ Total Assets and the Debt/ Total Assets ratios must each be lower than 33%. As for the qualitative screening procedures, the *Shari'ah* compliant firms must have a good public perception and the core activities of the firms are important and considered *maslahah* to the Muslim *ummah* (nation) and the country, and the non-permissible element is very small and involves matters such as *'ulum balwa*, *'uruf* (custom) and the rights of the non-Muslim community which are accepted by Islam (Malaysia International Islamic Finance Centre, 2013)⁶⁰. The non-permissible activities imposed on the *Shari'ah* compliant firms are *riba* (interest), *maysir* (gambling and gaming), *gharar* (uncertainty) like conventional insurance, and other prohibited activities like manufacturing or selling of non-*halal* products or related products, stockbroking or share trading in non-*Shari'ah* compliant securities and other activities that are not in harmony with *Shari'ah* principles. In order to ensure continuous compliance to the *Shari'ah* principles, these *Shari'ah*-compliant firms will be periodically screened by the SAC.

Even though these are the most common issues of concern in the literature of corporate financing, studies relating to the agency

⁶⁰Shariah Screening Methodology: Adopting A Two-Tier Quantitative Approach, accessed June 18, 2017, <http://www.mifc.com/?ch=28&pg=72&ac=54&bb=uploadpdf>

conflict when examining the impact of ownership structure on capital structure decision of *Shari'ah*-compliant firms is almost nil. Being restricted by certain regulations and the limitation imposed on the debt ratio may also have certain degree of influence in the financing decision of these *Shari'ah*-compliant firms, thus demands further research. Therefore, the study embarks with the objective to investigate the influence of ownership structure on debt financing decisions of *Shari'ah*-compliant firms in Malaysia. The findings of this study will definitely fill the gap and contribute significantly to the body of knowledge pertaining to the impact of ownership structure on the capital structure of *Shari'ah*-compliant firms and the insights can also be shared and referred to by other *Shari'ah*-compliant firms around the world in managing their agency conflicts as well as in determining their financing decisions.

The rest of the study is organised as follows. The next session deals with the theoretical framework of debt financing and ownership structure as well as the nature of *Shari'ah*-compliant firms and follows by an overview of some related studies. The data and methodology is explained in the fourth section follows by the results and discussion of the findings. The final section concludes the study.

2.1 Capital Structure Theories and Family-Owned Ownership

Ever since the seminal work in the corporate financing literature,⁶¹ researchers have been discussing, examining and testing several propositions in explaining the financing decisions of firms worldwide. En route the numerous investigations three dominant theories have emerged among others, which are the pecking order theory, the trade-off theory and the agency theory. The pecking order theory explains that firm usually will prefer internal source of financing when deciding on their capital structure. This is because of informational asymmetry problems that may arise between the manager and outside lender thus hinders the firm's preference for outside financing. Nevertheless, firm might have to engage with debt when internal financing is no longer sufficient to finance its operation

⁶¹ F. Modigliani and M. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment." *American Economic Review*, 48(3), (1958), 265.

and outside equity will be the last option.⁶² Regarding the family owned firms, this kind of ownership orientation is usually associated with informational opacity making information asymmetry problem more intense thus enhances the internal financing preference.⁶³ Family-owned firms also have full control over the funds and wealth of the firms and will strategize their financing decision in the manner that no intruders will be able to interfere in the management of the firm.⁶⁴ Therefore, to avoid information asymmetry problem, to lessen the fear of losing control of the firm and to satisfy the desire to pass the firm down to their family members,⁶⁵ have made external financing not an option to these family-owned firms thus explain the hierarchical choice of financing.

Another dominant theory often being referred to in explaining the financing decision of firms is the agency theory. This theory explains that when agency conflicts between shareholders, managers and debt holders are mitigated an optimal capital structure will be achieved. In view of family-owned firms, managers and shareholders interest pertaining to growth and risks are normally aligned. Hence, the degree of the agency conflict will be very small.⁶⁶ This alignment of interest between shareholders and managers of family-owned firm minimizes agency cost as both the manager and shareholders are normally among the family members.⁶⁷ Nonetheless,⁶⁸ do caution of the existence of wealth expropriation at the expense of the minority shareholders. This phenomenon is seen

⁶² S.C. Myers and N.S. Majluf, "Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have." *Journal of Financial Economics*, 13(2), (1984), 191.

⁶³ C.A. Utama, S. Utama and F. Amarullah, "Corporate Governance and Ownership Structure: Indonesia Evidence." *Corporate Governance: The International Journal of Business in Society*, 17 (2), (2017), 170.

⁶⁴ R.W. Carney and H.N. Hart, "What Do Changes in Corporate Ownership in Indonesia Tell Us?." *Bulletin of Indonesian Economic Studies*, 51(1), (2015), 128.

⁶⁵ F.K. Thiele and M. Wendt, "Family Firm Identity and Capital Structure Decisions." *Journal of Family Business Management*, 7(2),(2017), 228.

⁶⁶ M.C. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." 315.

⁶⁷ R. Anderson and D. Reeb, "Founding-Family Ownership, Corporate Diversification, and Firm Leverage." 668.

⁶⁸ A. Shleifer and R.W. Vishny, "A Survey of Corporate Governance." 750.

as a big disadvantage of family-owned firms. When debt is seen as not functioning much in disciplining managers in family-owned firms, it does function effectively in mitigating the expropriation of wealth in the firm.⁶⁹

The trade-off theory, on the other hand, emphasizes on striving for optimal capital structure by balancing off the benefit of debt like tax shield and cost of debt like bankruptcy risk and insolvency. When the cost of debt and the benefit of debt are at the equilibrium firm performance will be enhanced and consequently increases firm value.⁷⁰ Regarding family owned firms, family gains private benefit by having full control of the firm. Nevertheless, this type of ownership orientation usually pursues lower investment or undiversified which might lead to bankruptcy risk and insolvency thus may put private benefits at risk. Consequently, family-owned firms will limit their debt consumption as to reduce the risks that come with debt though it means letting go of profitable projects.⁷¹ These fears drive family owned to consume less debt in their capital structure. Despite being known to have certain characteristics that can ease agency cost to the firms in terms of monitoring cost, lenders are more willing to lend considering the minimum monitoring cost of the firm. Family-owned firm is normally associated with greater availability of credit and a lower cost of debt financing thus encourages debt employment in the capital structure.⁷² Should they need external financing, these family-owned firms will opt to debt over equity as to avoid dilution of control over the firm and will strategies accordingly to ensure longevity and succession in the long

⁶⁹ L. Setia-Atmaja, G.A. Tanewski and M. Skully, "The Role of Dividends, Debt and Board Structure in the Governance of Family Controlled Firms." *Journal of Business Finance and Accounting*, 36(7), (2009), 868.

⁷⁰ A. Kraus and R.H. Litzenberger, "A State Preference Model of Optimal Financial Leverage." *Journal of Finance*, 28(1), (1973), 915.

⁷¹ S. Mulyani, A.M. Janni and D. Khamimah, "Policy on Entry in the Use of Intellectual Property Rights (Mark) Denotes Intangible Asset as Fiduciary Security Object Efforts to Support Economic Development in Indonesia." *International Journal of Business, Economics and Law*, 5(4), (2014), 53.

⁷² E. Croci, J.A. Doukas and H. Gonenc, "Family Control and Financing Decisions." *European Financial Management*, 17(5), (2011), 870.

run, not merely economic goals.⁷³

2.2 *Shari'ah*-Compliant Firms

Looking at the characteristics of the *Shari'ah*-compliant firms, there is an influence of the pecking order theory in the capital structure where internal financing is the most preferred comparative to debt or equity.⁷⁴ This is because being *Shari'ah*-compliant, their aim is to minimise cost of capital thus internal financing is the best option. Since there are Islamic financing instruments available in the market to suit the demand of these *Shari'ah*-compliant firms, they would accordingly go for internal financing, then debt financing in the form of *ijarah* (lease contract) or *murabahah* (sale contract of asset at a mark-up) and finally *mudaraba*-based (silent partnership) or *musharaka*-based (partnership that share both in capital and management) equities.

Despite being governed by certain *Shari'ah* regulations, debt financing is almost unavoidable for *Shari'ah*-compliant firms. To tackle this issue, one of the regulations is that debt must be asset-backed. This means that the debt ratio in a *Shari'ah* compliant-firm must not exceed the value of its tangible assets.⁷⁵ This is to avoid default in loan repayment thus firms with lesser tangible assets are able to secure less debt in their financing. What distinguishes Islamic debt from conventional debt is that the former is necessarily asset-backed and hence, the significant amount of total debt would be bounded by the tangible assets owned by the *Shari'ah*-compliant firms.⁷⁶

2.3 Related Ownership Structure Studies and *Shari'ah*-Compliant Firms

Several studies have been documenting interesting results pertaining

⁷³ F.K. Thiele and M. Wendt, "Family Firm Identity and Capital Structure Decisions." 232.

⁷⁴ H. Ahmed, "Corporate Finance: Capital Structure in Firms." IRTI Research Paper Series, 70, (2007), 8.

⁷⁵ Ibid, 12.

⁷⁶ M. Obaidullah, "Teaching Corporate Finance from an Islamic Perspective." Islamic Economics Research Centre, King Abdul Aziz University (2007), 12.

to the influence of ownership structure on capital structure on various economic landscapes. The level of risks the firm incurs determines the level of debt engagement of a family-owned firm.⁷⁷ They find a significant positive relationship between family-owned firm and debt financing implying that the benefit of debt is substantial as compared to the cost of debt. However, family-owned firms are risk averse and will avoid debt financing which usually comes with bankruptcy risks.⁷⁸ These firms as discussed earlier are more concern over the long life of the firm rather than the economic goals. Family owned firms normally use their voting right to influence the manager's decision making thus can act as monitoring mechanism rather than using debt. This is translated into a negative relationship between family-owned firms and debt financing.⁷⁹ Family-owned firms face very minimum agency problem due to a much lesser conflict between the shareholders and the managers being in the same family with an alignment of interest between them.⁸⁰

In view of the *Shari'ah*-compliant firms, as mentioned earlier not many studies have been done investigating the *Shari'ah*-compliant debt financing decision in the account of agency conflict and ownership structure. Haron and Ibrahim⁸¹ in their study on *Shari'ah*-compliant firms in Malaysia from 2000-2009 report that despites being restricted by certain *Shari'ah* regulations, similar factors are seemed to significantly affect the firms' debt financing decision just like the conventional firms. Ismail et al.⁸² study 30 *Shari'ah*-compliant construction firms in Malaysia and they agree to

⁷⁷ D. Margaritis and M. Psillaki, "Capital Structure, Equity Ownership, and Firm Performance." *Journal of Banking and Finance*, 34, (2010), 625.

⁷⁸ T. Schmid, "Control Considerations, Creditor Monitoring, and the Capital Structure of Family Firms." *Journal of Banking and Finance*, 37(2), (2013), 260.

⁷⁹ F.K. Thiele and M. Wendt, "Family Firm Identity and Capital Structure Decisions." 232.

⁸⁰ Utama, C.A., Utama, S. and Amarullah, F, "Corporate Governance and Ownership Structure: Indonesia Evidence." 175.

⁸¹ R. Haron and K. Ibrahim, "Target Capital Structure and Speed of Adjustment: Panel Data Evidence on Malaysia Shariah Compliant Securities." *International Journal of Economics, Management and Accounting*, 20(2), (2012), 90.

⁸² F. Ismail, N. Nordin and Z. Zainuddin, "Firms' Financing Behavior: A Look into Shariah-Compliant Construction Firms in Malaysia." *International Journal of Economics and Financial Issues*, 6(7S), (2016), 18.

what Haron⁸³ has said about inconclusiveness of the capital structure studies. Mixed results are recorded on the determining factors and no single theory is able to independently explain the financing choices of the firms and Ismail et al.⁸⁴ confirms it.

Ahmad and Azhar⁸⁵ find tangibility and profitability inversely affect the debt financing of *Shari'ah*-compliant firms in Malaysia. According to them this might be because of the 33% debt ratio imposed on the *Shari'ah* firms thus discourage firms to engage with more debt. A very recent study by Thabet et al.⁸⁶ document an inversed relationship between non debt tax shield (NDTS), profitability and business risk with debt financing. This, according to them is an indication of the influence of pecking order theory in their debt financing decision considering the nature of these *Shari'ah*-compliant firms.

Not many or almost nil studies have been done investigating the ownership structure of *Shari'ah*-compliant firms in the account of the agency conflict on capital structure choices. Most studies on corporate governance with regards to *Shari'ah*-compliant deal with the issue and the influence of board of directors and the CEO duality (see for examples, Amran and Che Ahmad,⁸⁷ Alkdai and Hanefah⁸⁸) and the number of Muslim directors on the board (Amran and Che Ahmad⁸⁹) on the performance of the firms.

⁸³ R. Haron, "Capital Structure Inconclusiveness: Evidence from Malaysia, Thailand and Singapore." *International Journal of Managerial Finance*, 10(1), (2014), 34.

⁸⁴ F. Ismail, N. Nordin and Z. Zainuddin, "Firms' Financing Behavior: A Look into Shariah-Compliant Construction Firms in Malaysia." 22.

⁸⁵ N. Ahmad and N.N. Azhar, "Investigating of Shariah Compliant Companies Capital Structure Determinants." *Advanced Science Letters*, 21(6), (2015), 1988.

⁸⁶ O. Thabet, F.A. Shawtari, A.M. Ayedh and F. Ali, "Capital Structure of Malaysian Shari'ah-Compliant Firms." *JKAU: Islamic Econ*, 30(1), (2017), 110.

⁸⁷ N.A. Amran and A. Che Ahmad, "Corporate Governance Mechanism and Performance: Analysis of Malaysia Family and Non-Family Controlled Companies." *Journal of Modern accounting and Auditing*, 6(2), (2010), 2.

⁸⁸ H.K. Alkdai and M.M. Hanefah, "Board of Directors' Characteristics and Value Relevance of Accounting Information in Malaysian Shariah-Compliant Companies: A Panel Data Analysis." *Economics and Finance Review*, 2(6), (2012), 31-44.

⁸⁹ N.A. Amran and A. Che Ahmad, "Corporate Governance Mechanism and Performance: Analysis of Malaysia Family and Non-Family Controlled Companies." 3.

3.0 Determinants of capital structure and hypotheses development

Firm level determinants

The corporate financing literature is witnessing an increasing attention being given to ownership concentration and its impact on capital structure (Driffield et al.⁹⁰) apart from the common firm level determinants like the non-debt tax shield (NDTS), firm size, business risk, tangibility, liquidity, profitability, intangibility and growth. Frank and Goyal⁹¹ acknowledge these determinants as the core factors in capital structure empirical study.

Ownership concentration

Debt is commonly used as a controlling tool to curb managers from adjusting the capital structure to suit their own self-interest. Firms with high level of ownership concentration are very concern over ownership dilution thus may prefer debt over equity if they need to engage with external financing. This implies a positive relationship between concentrated ownership and debt financing and Li et al.⁹² supports this in his study on firms in China. Studies like Driffield et al.⁹³ and Cespedes et al.⁹⁴ also find positive relationship between concentrated ownership and capital structure.

On the other hand, shareholders in a concentrated ownership firm can function effectively as a disciplinary tool to monitor the managers' action as oppose to debt.⁹⁵ Thus a negative relationship between ownership concentration and debt financing is expected.

⁹⁰ N. Driffield, V. Mahambare and S. Pal, "How Does Ownership Structure Affect Capital Structure and Firm Value? Recent Evidence from East Asia." *Economics of Transition*, 15(3), (2007), 538.

⁹¹ M.Z. Frank and V.K. Goyal, "Capital Structure Decisions: Which Variables Are Reliably Important?." *Financial Management*, 38(1), (2009), 5.

⁹² K. Li, H. Yue and L. Zhao, "Ownership, Institutions, and Capital Structure: Evidence from China." *Journal of Comparative Economics*, 37(1), (2009), 476.

⁹³ N. Driffield, V. Mahambare and S. Pal, "How Does Ownership Structure Affect Capital Structure and Firm Value? Recent Evidence from East Asia." 540.

⁹⁴ J. Cespedes, M. Gonzalez and C.A. Molina, "Ownership and Capital Structure in Latin America." *Journal of Business Research*, 63(3), (2010), 248-254.

⁹⁵ M.C. Jensen and W. Meckling "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." 322.

Moreover, there is a tendency of expropriation of wealth by the controlling shareholder at the expense of the minority shareholders thus may increase agency cost for debt making debt less attractive.⁹⁶ In this study, ownership concentration is measured based on the shareholdings of 5 per cent and above.⁹⁷ The hypothesis for this variable is that: H₁: Ownership concentration has a positive influence on debt financing.

Ownership Identity (Family-Owned)

Family owned firms always emphasize on longevity and succession in their financing decision and will make sure that the firm will stay in the hand of the family for as long as it takes.⁹⁸ Bearing that in mind, family-owned firms will strive for long term commitment with lenders to ensure stable and secured financing thus build good rapport with the lender. With this good rapport, this type of ownership structure is usually associated with greater availability of credit and much lower cost of debt financing.⁹⁹ Consequently, family-owned firms become more leveraged than other types of ownership structure. Setia-Atmaja et al.¹⁰⁰ and Gottardo and Moisello¹⁰¹ report a positive relationship between ownership identity (family-owned) and debt financing.

However, ownership identity can also have a negative relationship with debt financing following the main agenda and interest of the firm.¹⁰² Consuming high level of debt is often

⁹⁶ Y. Liu, Y. Li and J. Xue, "Ownership, Strategic Orientation and Internationalization in Emerging Markets." *Journal of World Business*, 46(3), (2011), 381-393.

⁹⁷ C.A. Utama, S. Utama and F. Amarullah, "Corporate Governance and Ownership Structure: Indonesia Evidence." 180.

⁹⁸ N. Driffield, V. Mahambare and S. Pal, "How Does Ownership Structure Affect Capital Structure and Firm Value? Recent Evidence from East Asia", 542.

⁹⁹ F.K. Thiele and M. Wendt, "Family Firm Identity and Capital Structure Decisions", 234.

¹⁰⁰ L. Setia-Atmaja, G.A. Tanewski and M. Skully, "The Role of Dividends, Debt and Board Structure in the Governance of Family Controlled Firms", 875.

¹⁰¹ P. Gottardo and A. Maria Moisello, "The Capital Structure Choices of Family Firms: Evidence from Italian Medium-Large Unlisted Firms." *Managerial Finance*, 40(3), (2014), 254-275.

¹⁰² N. Driffield, V. Mahambare and S. Pal, "How Does Ownership Structure Affect

translated to high level of bankruptcy risks thus, being a risk averse, family-owned firm will definitely avoid debt in their financing strategy. Thus, these firms will be very much underleveraged as compared to their non-family owned firms. The alignment of interest between shareholders and managers being a family-owned firm minimizes the agency cost thus makes issuing debts as manager's disciplinary tool less crucial. Schmid¹⁰³ report a negative relationship between family-owned and debt financing in his studies. This study therefore hypothesize that: H₂: Ownership identity (family owned) has a negative influence on debt financing. This study uses dummy code of '1' for family-owned firms while '0' for non-family owned firms. The status of the firm, either family-owned or non-family owned is based on shares directly owned by the executive directors of the firm i.e. 5% and above.¹⁰⁴ A firm is categorized as family-owned firm if executive directors have shareholding of at least 5%.

Controlled Variables

Non Debt Tax Shield (NDTS)

Contending the proposition of the MM irrelevance theory, taxes are then included in capital structure study and reveals that firms can reap substantial gains from tax shield. Nevertheless, there are possibilities of default in interest payments if higher debt level is employed which can lead to financial distress, bankruptcy risk and insolvency. But firms can still opt to tax loss carry forward, investment tax credits and depreciation or also known as non-debt tax shield (NDTS).¹⁰⁵ Since NDTS is a perfect alternative for tax shield from debt, NDTS should be negatively correlated with debt financing. Significant negative relationship between NDTS and debt financing is reported in Haron and Ibrahim¹⁰⁶ and Thabet et al.¹⁰⁷

Capital Structure and Firm Value? Recent Evidence from East Asia", 548.

¹⁰³ T. Schmid, "Control Considerations, Creditor Monitoring, and the Capital Structure of Family Firms." *Journal of Banking and Finance*, 37(2), (2013), 261.

¹⁰⁴ F.K. Thiele and M. Wendt, "Family Firm Identity and Capital Structure Decisions", 226.

¹⁰⁵ M.Z. Frank and V.K. Goyal, "Capital Structure Decisions: Which Variables Are Reliably Important?", 7.

¹⁰⁶ R. Haron and K. Ibrahim, "Target Capital Structure and Speed of Adjustment:

NDTS is represented by annual depreciation expenses to total asset. Thus, following the literature, the hypothesis is, H₃: NDTS has a negative influence on debt financing.

Firm Size

The trade-off theory explains that larger firms have better access to a higher debt level as they are more diversified thus lesser tendency to fail, indicating a positive relationship. Being less affected by information asymmetry, debt financing is easily accessible. This notion is supported by Ameer¹⁰⁸. However, Haron and Ibrahim¹⁰⁹ depict a significant negative relationship between size and debt financing in their study on *Shari'ah*-compliant firms in Malaysia. Perhaps being *Shari'ah* compliant, those firms have to comply with the 33% debt ratio benchmark imposed on them thus reduces the level of debt consumption in the capital structure. Firm size is represented by natural logarithm of total asset. The hypothesis is that: H₄: Firm size has a positive influence on debt financing.

Business Risk

Earnings volatility is commonly translated as business risk of firms. Higher earnings volatility may increase the risk of default on debt payments. Therefore debt financing should be avoided indicating a negative relationship with business risk. Ameer¹¹⁰ and Haron¹¹¹ find negative relationship between risk and debt financing. Firms with high degree of risk may prefer equity issuance to debt for business expansion and competencies. As a result, equity holders would seek for higher return as compensation to the higher risk taken

Panel Data Evidence on Malaysia Shariah Compliant Securities”, 96.

¹⁰⁷ O. Thabet, F.A. Shawtari, A.M. Ayedh and F. Ali, “Capital Structure of Malaysian Shari'ah-Compliant Firms”, 111.

¹⁰⁸ R. Ameer, “Financial Liberalization and Firms’ Capital Structure Adjustments Evidence from Southeast Asia and South America.” *Journal of Economics and Finance*, 37(1), (2010), 6.

¹⁰⁹ R. Haron and K. Ibrahim, “Target Capital Structure and Speed of Adjustment: Panel Data Evidence on Malaysia Shariah Compliant Securities”, 99.

¹¹⁰ R. Ameer, “Financial Liberalization and Firms’ Capital Structure Adjustments Evidence from Southeast Asia and South America”, 11.

¹¹¹ R. Haron, “Do Indonesian Firms Practice Target Capital Structure? A Dynamic Approach.” *Journal of Asia Business Studies*, 10(3), (2016), 322.

on investment. Business risk is represented by yearly change in the firm EBIT. Here, the hypothesis is: H₅: Business risk has a negative influence on debt financing.

Asset Tangibility

Tangible assets act as collateral and help firms to secure debt financing. The trade-off theory explains that firms with high tangible assets are able to secure more debt as these assets are easier to repossess in case of bankruptcy, thus indicating a positive relationship. Moosa and Li¹¹² find positive relationship between tangibility and debt financing. However, the pecking order theory explains that firms with high tangible assets employ less debt as they rely more on internal fund generated from these tangible assets, implying a negative relationship. Ahmad and Azhar¹¹³ confirm a negative relationship in their study on *Shari'ah*-compliant firms in Malaysia. This study uses the ratio of fixed assets to total assets as a proxy for tangibility. As for tangibility, the hypothesis is that: H₆: Asset tangibility has a positive influence on debt financing.

Profitability

Asymmetric information problem is a concern and can affect the financing choice of a firm. Managers of firms with high profit and cash flows might opt to internal resources first when deciding on investment financing as a mean to mitigate information asymmetry as these are the cheapest funds rather than using external financing, either debt or equity. Hence, profitability is expected to affect debt financing negatively indicating the support of the pecking order theory. Haron¹¹⁴ and Thabet et al.¹¹⁵ share similar result of negative relationship between profitability and debt financing. Firm's

¹¹² I. Moosa and L. Li, "Firm Specific Factors as Determinants of Capital Structure. Evidence from Indonesia." *Review of Pacific Basin Financial Markets and Policies*, 15(2), (2012), 8.

¹¹³ N. Ahmad and N.N. Azhar, "Investigating of Shariah Compliant Companies Capital Structure Determinants." (1992).

¹¹⁴ R. Haron, "Do Indonesian Firms Practice Target Capital Structure? A Dynamic Approach." 328.

¹¹⁵ O. Thabet, F.A. Shawtari, A.M. Ayedh and F. Ali, "Capital Structure of Malaysian *Shari'ah*-Compliant Firms", 111.

profitability is represented by Net Profit over total asset. Thus, the hypothesis for this variable is: H₇: Firm's profitability has a negative influence on debt financing.

Growth

According to the agency theory, growth firms will choose to issue equities to fund their operations and investments to signal to the outsiders that they are not facing any underinvestment and asset substitution problems. Therefore, growth is expected to relate negatively with debt financing. Similarly, the pecking order theory also posits a negative relationship between growth and debt financing. This is due to the fact that growing firms are expected to have substantial accumulated retained earnings. When retained earnings are high, debt level will be very minimal. Moosa and Li¹¹⁶ support this negative relationship. Growth is represented by market value of equity over book value of equity. Following literature, the hypothesis is: H₈: Firm growth has a negative influence on debt financing.

4.0 Data and Methodology

This study utilizes an unbalanced panel data that includes 556 *Shari'ah*-compliant non-financial firms covering the period of 2000-2015. The firms' data on ownership are manually extracted from the annual reports of the firms since it is not available from on-line database. The annual reports are downloaded from the Bursa Malaysia website, while data on controlled variables are extracted from the DataStream database. Only firms that have been listed in Bursa Malaysia at least from 2013 (minimum three year observations) are included in the study sample.

This study performs a panel regression to examine the influence of ownership and ownership identity after controlling for NDTs, firm size, business risk, asset tangibility, profitability and growth. The panel regression is estimated based on the Generalized Method of Moment (GMM), an estimator that is widely used in capital structure studies. One of the main advantages of GMM is that,

¹¹⁶ I. Moosa and L. Li, "Firm Specific Factors as Determinants of Capital Structure. Evidence from Indonesia", 12.

it efficiently addresses endogeneity issue in panel data compared to other panel regression methods like the Ordinary Least Square (OLS), Fixed Effect and the Random Effect. The endogeneity issue is addressed by using an instrumental variable in the model. To confirm the validity of the instrumental variable used, a standard procedure is followed by conducting a diagnostic test (Sargan test – Null: Instrumental variable is valid). In addition, this study also performs other diagnostic tests such as the Wald test (Null: coefficients are not equal zero), serial correlation test (AR(2) – Null: No serial correlation in the residuals) and the multicollinearity test by performing the variance inflation factor (VIF). The GMM used in this study is confirmed to be an efficient estimator since it satisfies all the diagnostic tests. Being efficient, the regression result hence is not spurious and is reliable.

The panel regression model is explained as following:

$$\begin{aligned} Debt_{it} = & \beta_0 Debt_{it(-1)} + \beta_1 Own_{it} + \beta_2 OwnID_{it} \\ & + \beta_3 NDTs_{it} + \beta_4 Size_{it} + \beta_5 Risk_{it} \\ & + \beta_6 Tang_{it} + \beta_7 Prof_{it} + \beta_8 GROW_{it} + \varepsilon_{it} \end{aligned}$$

where $Debt_{it}$ is represented by $\frac{TD}{TA}$, $Debt_{it(-1)}$ represents the lag debt and Own_{it} and $OwnID_{it}$ represent concentrated ownership and ownership identity, respectively. $NDTS$ (non-debt tax shield), $SIZE$ (firm size), $RISK$ (business risk), $TANG$ (asset tangibility) and $GROW$ (growth) are the controlled variables, while ε_{it} is the error term.

5.0 Results and Analysis

5.1 Descriptive Statistics

Table 1 reports the descriptive of data used in this study. *Shari'ah*-compliant firms consume debt on average 20.04 percent in its capital structure, below the 33% maximum benchmark as determined by the SAC. In term of concentrated ownership, on average 47.67% of shareholdings are greater than 5 percent. This

indicates that the ownership structure of *Shari'ah*-compliant firms is highly concentrated. As for ownership identity, statistic shows that based on the mean, the sample firms are almost balanced in term of firms that are owned by family and non-family.

Table 1. Descriptive Statistics

Variable	Mean	Maximum	Minimum	Median	Standard Deviation
Debt	0.2004	0.9859	0.0000	0.1743	0.6972
Ownership	0.4737	0.9981	0.0000	0.4929	0.0210
Ownership ID	0.5127	1.0000	0.0000	1.0000	0.4999
NDTS	0.0218	0.5934	0.0000	0.0168	0.0240
Size	12.0829	17.6784	2.4849	11.9736	1.4455
Risk	-3.6073	512.7500	-10860.0000	-0.0301	174.7692
Tangibility	0.3802	0.9875	0.0000	0.3724	0.2135
Profitability	0.0343	28.4701	-3.0172	0.0352	0.3953
Growth	1.4228	1888.7273	-240.2468	0.8125	22.2246

5.1 Determinants of debt financing

Based on Table 2, seven determinants which are ownership, ownership identity, NDTS, firm size, business risk, asset tangibility, profitability and growth are found to significantly influence the debt financing decision of *Shari'ah*-compliant firms throughout the period understudy.

This study depicts a negative relationship between ownership and debt financing. Higher level of concentrated ownership has a negative influence on debt financing ($p=0.01$), in contrast to H_1 in which a positive relationship is expected. Perhaps the shareholders function well as a disciplinary tool to monitor the managers' action rather than debt thus explains the negative relationship. Moreover,

being a *Shari'ah*-compliant, the use of debt is restricted to certain percentage thus is not reliable enough to be used as a controlling mechanism. This negative relationship is in line with Liu et al.¹¹⁷

In terms of ownership identity, family owned firms is found to consume more debt compared to the non-family owned firms ($p=0.01$), in contrast to H_2 , a negative relationship. Family owned firms usually as discussed earlier, will strive for long term commitment with lenders to ensure stable and secured financing thus build good rapport with the lender. With this good rapport, this type of ownership structure is usually associated with greater availability of credit and much lower cost of debt financing, thus explains the positive relationship. Looking at *Shari'ah*-compliant characteristics, perhaps these firms engage with debt to the maximum level permissible as to ensure good commitment with the lender and perhaps engage with Islamic financial instruments available in the Islamic capital market like *sukuk* which encourages debt consumption.

This study records a negative relationship between NDTs and debt financing ($p=0.01$) thus H_3 is supported. *Shari'ah* compliant firms may not consider debt in their financing due to the restriction imposed on the level of debt in their capital structure thus may opt to NDTs as explained by the trade-off theory. Furthermore, debt is very much avoided by family owned firms being risk averse thus explains the negative relationship. Haron and Ibrahim¹¹⁸ and Thabet et al.¹¹⁹ also find negative relationship between NDTs and leverage.

A negative relationship is reported between size and debt financing ($p=0.01$), in contrast to H_4 in which a positive relationship is expected. Haron¹²⁰ also depict a significant negative relationship between firm size and debt financing in their study. Again the restriction on debt employment may perhaps be the reason on the

¹¹⁷ Y. Liu, Y. Li and J. Xue, "Ownership, Strategic Orientation and Internationalization in Emerging Markets", 388.

¹¹⁸ R. Haron and K. Ibrahim, "Target Capital Structure and Speed of Adjustment: Panel Data Evidence on Malaysia Shariah Compliant Securities", 95.

¹¹⁹ O. Thabet, F.A. Shawtari, A.M. Ayedh and F. Ali, "Capital Structure of Malaysian Shari'ah-Compliant Firms", 111.

¹²⁰ R. Haron, "Do Indonesian Firms Practice Target Capital Structure? A Dynamic Approach", 332.

negative relationship between firm size and debt financing for these *Shari'ah*-compliant firms. Furthermore, looking at the nature of family-owned firms, the fear of power dilution will reduce the level of debt in the capital structure. The larger the firms the more retained earning they have accumulated thus debt is the least choice of financing, following the pecking order theory.

This study depicts a negative relationship between tangibility and debt financing ($p=0.01$). This finding however rejects H_6 . The pecking order theory explains that firms with high tangible assets employ less debt as they rely more on internal fund generated from these tangible assets, this explains the negative relationship. This finding also enhances the nature of *Shari'ah*-compliant firms which are expected to follow the hierarchical financing. This finding is consistent with Ahmad and Azhar¹²¹ but in contrast with Haron and Ibrahim¹²² and Thabet et al.¹²³ who record positive relationship. In addition, family-owned firm will avoid debt financing as to avoid risk that comes with debt and this notion supports the negative relationship as well.

Profitability is found to relate negatively with debt financing ($p=0.01$). H_7 is thus supported. Highly profitable firms choose to use their retained earnings to finance their investments. This finding is in line with Ahmad and Azhar¹²⁴ and Thabet et al.¹²⁵ where negative relationship is found between profitability and debt financing of *Shari'ah*-compliant firms. For the case of family-owned firms, using retained earnings can become the main agenda as to avoid dilution of power and unnecessary intrusion from outsiders via equity financing.

This study confirms the earlier finding by De Jong et al.¹²⁶ on

¹²¹ N. Ahmad and N.N. Azhar, "Investigating of Shariah Compliant Companies Capital Structure Determinants", 1998.

¹²² R. Haron and K. Ibrahim, "Target Capital Structure and Speed of Adjustment: Panel Data Evidence on Malaysia Shariah Compliant Securities", 98.

¹²³ O. Thabet, F.A. Shawtari, A.M. Ayedh and F. Ali, "Capital Structure of Malaysian Shari'ah-Compliant Firms.", 111.

¹²⁴ N. Ahmad and N.N. Azhar, "Investigating of Shariah Compliant Companies Capital Structure Determinants", (1992).

¹²⁵ O. Thabet, F.A. Shawtari, A.M. Ayedh and F. Ali, "Capital Structure of Malaysian Shari'ah-Compliant Firms", 111.

¹²⁶ A. De Jong, A., R. Kabir and T.T. Nguyen, "Capital Structure around the World:

the negative relationship between growth and debt financing ($p=0.01$), supporting H_8 in line with the agency theory and pecking order theory. Agency theory proposes that growth firms will choose to issue equities to fund their operations and investments to signal to the outsiders that they are not facing any underinvestment and asset substitution problems. Pecking order theory explains that growing firms are expected to have substantial accumulated retained earnings and with high retained earnings, debt financing will be very minimal. However, this study cannot find support on the influence of business risk on debt financing structure of these firms.

Table 2. Determinants of Debt Financing

Debt Financing Explanatory Variables	TD/TA	VIF
Debt(-1)	0.2236***[14.4405]	
Ownership	-3.6859***[-23.0040]	1.02
Ownership Identity	0.2493***[5.5345]	1.03
NDTS	-10.0417***[-11.6000]	1.75
Size	-0.6846***[-5.4196]	1.12
Risk	0.0018[1.2565]	1.01
Tangibility	-0.7912***[-5.2401]	1.25
Profitability	-2.6177***[-8.9964]	1.03
Growth	-0.1497***[-12.7692]	1.58
AR(1) <i>m</i> -statistic	-1.5145	
<i>p</i> -value	0.1299	
AR(2) <i>m</i> -statistic	-0.8690	
<i>p</i> -value	0.3848	
<i>J</i> -statistic	85.7800	
<i>p</i> -value	0.3955	
Wald Test (<i>F</i> -statistic)	199.3783***	

the Roles of Firm-and Country-Specific Determinants.” *Journal of Banking and Finance*, 32, (9), (2008), 1958.

<i>p</i> -value	0.0000
Observations	5807

Notes: ***, **, * denote probability values significant at 1%, 5% and 10% level respectively. The *t*-statistics in parenthesis are the *t*-values adjusted for White's heteroscedasticity consistent standard errors. The Wald test statistic refers to the null hypothesis that all coefficients on the determinants of debt financing are jointly equal zero; The *m*-statistic for AR(2) refers to the null of no second order correlation in the residuals; The *J*-test statistic for the null that the over identifying restrictions are valid. The VIF test of less than 10 confirms that there is no multicollinearity problem.

6.0 Conclusion

This study examines the impact of ownership and ownership identity on debt financing decisions of *Shari'ah*-compliant firms in Malaysia, with other firm level determinants as controlled variables. The result from this study is robust to heterogeneity, autocorrelation, endogeneity and multicollinearity concern.

The concentrated ownership phenomenon among the emerging market and in this case Malaysia does have a significant impact on debt financing of firms. The negative relationship recorded in this study may be explained by the reluctance of large shareholders to engage with debt financing as to avoid bankruptcy risk and the risk of losing the firm. In terms of family owned firms, it is revealed that family owned firms in Malaysia consume more debt compared to the non-family owned firms perhaps for several reasons depending on the management of the firm. Family owned firms usually as discussed earlier, will strive for long term commitment with lenders to ensure stable and secured financing thus build good rapport with the lender. With this good rapport, this type of ownership structure is usually associated with greater availability of credit and much lower cost of debt financing.

From the study, it is apparent that large firms with higher profitability in Malaysia seem to employ low level of debt for they fear of bankruptcy risk and insolvency. These large firms seem to use the non-debt tax shield in their capital structure as to avoid the cost of debt. Firms with high tangible assets seem to consume less debt in their capital structure. This must be due to the accumulated fund generated from these assets thus the need for debt financing lessens.

This is very much a typical characteristic of family-owned firms as well as being *Shari'ah*-compliant. Fear of risk that comes with debt hinders family-owned to consider debt financing in their capital structure. Furthermore, being *Shari'ah*-compliant, the use of debt is limited to certain percentage permissible following the *Shari'ah* regulation. All these distinctive features of family-owned and *Shari'ah*-compliant rationalize the findings in this study. The fear of bankruptcy risk and insolvency reflects the effect of trade-off theory and at the same time the pecking order theory is also in the picture when internal financing is more preferred.

The finding from this study has important policy implications. This study reflects the distinctive characteristic of family-owned as well as *Shari'ah*-compliant firms where debt financing is not the main preference in their capital structure. To maintain the controlling power and to be able to pass the firm to the next generation in of great concern of these family-owned firms instead of economic advantage. *Shari'ah*-compliant firms also have different agenda in deciding their financing decision where apart from economic wealth these firms are expected to serve the society and put *maqasid of Shari'ah* as the main agenda. Therefore, looking what have been revealed from the findings, this study contributes significantly to the existing literature with a deeper insight of the determinants of debt financing of *Shari'ah*-compliant firms in Malaysia. The very recent data set used and the robust methodology employed have indeed enriched the literature on Malaysia being an emerging market. The nature of family-owned firms does have great influence on the debt financing decisions and this input is a valuable contribution to the literature of corporate governance particularly regarding ownership concentration in terms of family-owned firms. The policy implications discussed earlier could definitely help in constructing better and more efficient policy in the future. Examining the debt financing of *Shari'ah*-compliant firms in the account of agency conflict and ownership structure is still very little or even close to nil. Thus, this study has indeed opened up to more potential research pertaining to the issue of corporate governance particularly the ownership structure of *Shari'ah*-compliant firms.

Being an emerging market, the findings can definitely be

extended as a base for future research in the area of corporate financing regardless of the economic landscape, whether developed or emerging market as both markets have been evidenced to share similar significant determinants in deciding the debt financing of the firms. Both developed and emerging markets can also learn from this case study of Malaysia especially on the impact of family-owned firms as well as *Shari'ah*-compliant firms on debt financing decisions. Other emerging markets with high ownership concentration level in their corporate governance can also learn from Malaysia as depicted in this study. Debt can be an effective controlling mechanism to discourage managers to manage cash flows and investments at their own self-interest. Debt can also act as a safeguarding mechanism as to avoid ownership dilution thus the large shareholder can maintain their controlling power in the firm. Yet, considering the *Shari'ah* principle, these firms are guided in their debt financing decision but still can wisely choose the Islamic financial instruments available in the market.